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TECHNICAL INSIGHT

COVID 19 DETERMINING MATERIALITY

COVID-19 is having a profound effect on many businesses and we can expect to see this continue into future financial reporting periods. Whether businesses are experiencing a temporary downturn as a result, or more radical changes, COVID-19 is likely to impact how materiality in audits is determined by auditors and the choice of benchmarks used.

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Introduction

Materiality is fundamental to an audit and is applied in planning and performing audits, as well as evaluating the effect of misstatements on the accounts.

There has been no change to the requirements in auditing standards on determining materiality. Auditors determine overall materiality at the planning stage of the audit, typically by applying a percentage to a chosen benchmark. Common benchmarks include profit before tax or normalised (ie. adjusted) profit before tax, total income or total expenses, gross profit, total assets or net assets. Auditors are required to use judgement to determine materiality and in considering whether misstatements are material. This judgement is affected by auditors' perceptions of the financial information needs of users of the accounts, and the size or nature (or both) of misstatements.

This Guide, *Materiality in the Audit of Financial Statements*, provides further information on the requirements.

Auditors will need to think about whether changes to businesses because of COVID-19 impact their determination of materiality. Auditors will need to make some difficult judgements about materiality and, importantly, will need to document them clearly in their audit files.

General Approach

It is likely that overall materiality will be set at a lower level than previously for some audits, which could increase the scope and extent of testing needed.

There may be some exceptions, for instance, businesses that have not been adversely affected by COVID-19, and are not expected to be in the future. For businesses that have experienced more fundamental and long-lasting adverse changes, auditors are likely to consider whether a more permanent change in the benchmark for determining overall materiality might be appropriate. For those businesses experiencing what is expected to be a more temporary downturn in activities, it is likely that auditors will want to maintain some consistency with benchmarks used in prior years, but will need to consider:

- what percentage to apply;
- whether lower specific materiality for certain account balances, classes of transactions and disclosures is needed; and
- the impact on performance materiality.

Considerations for auditors include:

- An agenda item at the audit engagement team planning meeting on the determination of materiality. This way the engagement team can discuss the factors that might have an impact on how it is to be determined and this discussion can be captured on the audit file.
- Ensuring that, in their involvement in determining materiality, the engagement partner provides the team with their insights into the impact of COVID-19 on materiality.
- Having early discussions with management and those charged with governance, to understand how they have performed over the period, any changes to the business and particular areas of sensitivity. Auditors will need to explain how these changes (and COVID-19 more generally) is likely to impact materiality, and the audit work performed.
- Performing a stand back test at the end of the planning stage, to assess the rationale for determining materiality. Given that materiality is determined at the overall level, at the performance level and, in some cases, separately for specific classes of transactions, account balances and disclosures, auditors run the risk of factoring in risks in multiple ways which could result in a loss of focus. This sense check would allow auditors to ask themselves whether the rationale makes sense and whether, as a result, the audit work is focusing on the significant risks and the areas where there is greater susceptibility to material misstatement.

Given the pervasive impact of COVID-19 on many businesses, auditors need to be mindful of the fact that materiality impacts the whole audit. Adjustments to the accounts may be needed if auditors only have forecast figures and in circumstances where there may be a higher risk of misstatements, for example, with home working. If auditors need to revise materiality downwards at a later stage in the audit, this is likely to result in additional audit work being performed.

Auditors may need to spend more time on determining materiality than they might ordinarily, and some conservatism may be appropriate.

Specific Considerations

Determining Overall Materiality

The following considerations might be helpful for auditors when determining overall materiality.

Has the underlying business remained the same and is the business a similar size to previous years?

Considerations might include whether projects have been put on hold, whether there has been any significant restructuring such as closure of offices or business lines, or closure of businesses during lockdown periods. Businesses might, as a result, have seen a decline in revenue and profit, but asset base values might not have changed significantly.

Considerations might also include whether new streams of business have been introduced (eg. different delivery models or diversification of businesses into new products/markets), the extent to which supply chains have been affected, the likelihood of assets being impaired, whether new financial arrangements have been negotiated (such as new bank funding or directors' personal guarantees) and the tightness of existing covenants.

Have the users of the accounts changed, or has their focus changed? Which KPIs are users interested in?

Changes in users or their focus may impact what benchmarks to use and whether there might be a need to set a lower specific materiality for specific account balances, classes of transactions or disclosures. An example might be where there are new sources of finance which might not only result in new users of the accounts, but also a change in focus. Users might, as a result, be more focused on the solvency and liquidity of businesses whereas, in the past, the focus was principally on financial performance. Users of accounts might also want to focus more on areas where there is increased risk of fraud and error in the accounts.

Considerations might include whether there is any over-optimism in significant estimates (such as the valuation of goodwill or inventory provisions), or risk that businesses might want to conceal other issues in an already 'bad' year or, where they may have had an exceptionally good year, that they may try to spread that success into the following year.

What is the reporting period and to what extent has it been impacted by COVID-19?

The timing of the reporting period needs to be considered as it may impact the determination of materiality and the appropriateness of benchmarks used. For example, a reporting period ending March 2020 may be less affected than a reporting period ending December 2020. If the period-end has been extended the auditors will need to consider whether the benchmark and percentage previously applied might still be appropriate for this period.

What benchmark has previously been used and is it appropriate in the current circumstances? What alternative benchmarks might there be?

One size will not fit all. Professional judgement is needed to determine an appropriate benchmark for each audit. The benchmark needs to be justifiable based on the auditors' perceptions of the financial information needs of the users of the accounts. An appropriate justification for a chosen benchmark would not be where it is done simply to avoid an increase in audit work as a consequence of a reduced materiality. Previous benchmarks used for determining materiality may not be appropriate, particularly where operations and/or revenues have significantly changed due to COVID-19.

Factors to consider include:

- **Volatility of the benchmark and whether averaging techniques have been used:** Is the benchmark appropriate given current circumstances and an assessment of future uncertainty and sustainability of the business? Using some form of averaging over more than one period (say, three or five years) might smooth out volatility, but auditors still need to be thinking about the focus of users of accounts. If there has been a step change in the business which may be a longer-term issue, averaging might not be the right approach. Also, past performance might not necessarily be a good indicator of future performance and so it might be better to consider a new benchmark. Auditors might otherwise just be deferring the decision to change benchmark to a future reporting period.

- **Where normalised benchmarks are used, for example, adjusted profit:** What types of adjustments are appropriate in the circumstances, for example, are exceptional items truly non-recurring given ongoing future uncertainty and how many years might it be appropriate to keep normalising? In the same way that auditors will advise audited entities not to just come up with a profit figure before the effects of COVID-19, it may not be appropriate for materiality to be determined by just stripping out the effects of COVID-19. In considering what adjustments to make it is important to understand what users will be focusing on.

- **Alternative benchmarks: If profit-based measures are not appropriate, would revenue or asset-based measures work?** Ordinarily, the balance sheet would not vary widely from one year to the next so total assets or net assets may be an appropriate benchmark, but auditors need to consider whether assets can be reliably measured in the current circumstances. In some cases, auditors may consider using a range of benchmarks. If a change in benchmark results in higher materiality, auditors need to consider whether this would be appropriate given the economic downturn.

Performance Materiality

Have the risks increased? For example, is there an increased risk of override of controls, fraud or error? Has the control environment changed?

Having determined overall materiality, auditors have another judgement to make in determining performance materiality. How much lower than overall materiality this will be depends on the auditors' assessed level of risk of material misstatement. Where the identified risks are higher, a lower threshold for performance materiality is likely to be needed.

Entity-specific risk and environmental factors feed into the auditors' determination of performance materiality. Considerations might include whether staff have been furloughed, whether the entity has accessed government grants, what covenant measures are in place, whether there are incentives for management bias and manipulation of the accounts and whether there have been any new transaction streams. Another factor that is likely to influence performance materiality is whether there are estimates in the accounts, as the current environment may lead to greater estimation uncertainty. The bigger the entity-specific risk, the more headroom auditors will need to build into performance materiality.

There may be changes to the control environment and the operational effectiveness of controls. Auditors need to understand how businesses are operating as the design and implementation of controls might have changed, as well as their effectiveness. For example, processes might have had to change, segregation of duties might have been lost and fewer reviews might be being performed, given a reduction in staff or increased levels of home working.

Lower Specific Materiality

Have line items become more material? Are there areas where there are increased risks? What are the areas of focus of users of the accounts?

Auditors will need to determine whether to set lower specific materiality for individual account balances, classes of transactions or disclosures. If businesses are close to covenant levels, then there may be areas of the accounts that will be of particular interest to users.

Auditors also need to think about any account balances, classes of transactions or disclosures that are qualitatively material ie. that given their nature, even a small change may influence the decisions of users of the accounts. For instance, users may be more interested in disclosures on the levels of government assistance, however small, the geographical split of turnover in businesses and directors' remuneration, so auditors may want to apply a lower specific materiality to these areas.

Auditors may determine overall materiality based on an asset-based benchmark, such as net assets, but then apply a lower specific materiality to specific items in the profit and loss account. This may be particularly relevant for charities, pension schemes and property companies where the numbers in the balance sheet are significantly higher.

Evaluating Misstatements

What are the implications for misstatements brought forward in opening balances? Are there misstatements that would be material because of their nature?

Auditors will need to consider both the size and nature of misstatements when evaluating them and deciding what is material. This will include consideration of disclosure misstatements, for example, if the auditor has concerns in relation to how the impact of COVID-19 is presented in the accounts.

Where materiality levels are significantly lower than prior years, auditors may need to do more work on opening balances and will need to consider the unadjusted misstatements brought forward within them.

Estimates are likely to be particularly challenging to audit given current and future uncertainties and auditors might therefore be looking at broader ranges.

Reassessing Materiality

Why might auditors need to reassess materiality and what are the implications for the audit?

Materiality assessments may need to be revised as the audit progresses if auditors become aware of information during the audit that would have caused them to determine a different amount initially.

This may, for example, be where overall materiality was determined prior to the entity's year-end based on forecast information and the actual figure for the auditors' materiality benchmark (such as profit before tax or revenue) differs significantly from the forecast or because material audit adjustments have been identified. The possibility of either occurring in the current environment is higher, particularly where there is a weaker control environment and increased risk of fraud or error. If after reassessment, a lower overall materiality is needed (and, if applicable, lower materiality levels for particular classes of transactions, account balances or disclosures), then it may also be necessary to revise performance materiality, and this might impact the nature, timing and extent of audit procedures. This is important and needs to be factored into the auditors' approach to determining overall materiality at the planning stage to avoid the need for auditors to have to redo their audit work applying a lower materiality or change the scope of an audit at a late stage in the audit process.

Group Audits

Are there specific group audit implications?

The considerations in this guide are also relevant to group audits.

Auditors are encouraged to plan the scope of the group audit early as the impact of COVID-19 on businesses might have specific implications for the group audit, such as:

- A need to set a lower materiality for components which will impact on the work required to be performed by component auditors;
- Some components of the group may now be considered to be significant under ISA 600, though not previously, and need a full scope audit; and
- Further components may now be brought into the scope of the group audit.

In planning the group audit, auditors are likely to have to determine materiality based on forecast numbers. They should be alert to the possibility of having to reassess materiality should the actual numbers be different as this could have significant implications for the performance of the group audit, particularly where component auditors are involved. These considerations should be factored into their initial determination.

Communication with Those Charged with Governance

Has materiality changed? Will more audit work be required?

So that expectations can be managed, auditors need to communicate their approach with those charged with governance early in the audit process, particularly if materiality is expected to change and where auditors are likely to be taking a tougher approach to adjusting for misstatements. If materiality is set at a lower level than previously, auditors are encouraged to have upfront discussions with those charged with governance about fees, on the basis that more audit work will need to be performed as a result.

Audit Report Implications

What are the implications for auditors communicating key audit matters in their audit report?

ISA (UK) 701 applies to audits of listed entities, non-listed public interest entities, entities that are required, and those that choose voluntarily, to report on how they have applied the UK Corporate Governance Code and where auditors have voluntarily decided to communicate key audit matters in the audit report.

Where this applies, auditors need to be mindful of their responsibilities to include an explanation in the audit report of the significant judgements made in determining both overall materiality and, for periods commencing on or after December 15, 2019, performance materiality. Such disclosures would include the rationale for a change in basis or any significant revisions to both overall and performance materiality through the course of the audit.

Documenting Rationale

Does the audit file reflect the rationale for how materiality has been determined by the auditors?

Materiality is a hugely challenging area for auditors and one that will require judgement in the current circumstances. There is no single 'right' answer but poor documentation (including on materiality) is one of the most common audit file failings and so auditors should be seeking to ensure that the rationale – the thought processes they have gone through and factors they have taken into account – are well documented in the audit files.

If auditors are using the same benchmark and percentage as the prior period, the file needs to reflects why, and how, they remain relevant in the current circumstances.