Snapshot 2: Communicating judgements on materiality and the scope of group audits

Introduction

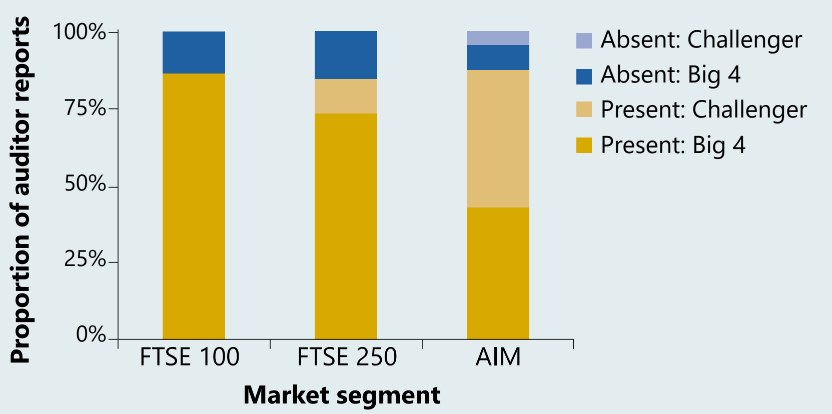
Auditor reporting requires auditors to provide information about the thresholds and significant judgements made in relation to materiality, as well as providing an overview of the scope of the audit. The determination of materiality is affected by the auditor's perception of the financial information needs of users of the financial statements. For group audits, judgements over which components to scope into audit procedures as well as the coverage achieved by these procedures provides useful information to users on the audit approach. This snapshot reports on how auditor's reports issued during 2021 for FTSE 350 and large AIM companies communicated these matters.

2 Judgements on the selection of materiality benchmarks

Providing an explanation of how materiality has been set conveys important information to users of financial statements. These explanations frequently state that the selected metric was identified as the key metric used by stakeholders to assess financial performance.

Figure 4 shows how the inclusion of explanations on materiality varied between the three different market segments. The inclusion of this information is consistent between different FTSE 100, FTSE 250, and large AIM companies, with over 85% of reports including this information across all segments. The principal reason for this pattern is that one firm did not consistently include this information in all its auditor's reports, alongside a handful of reports issued by other firms.

Fig. 4: Provision of explanations for the materiality benchmark



1 Types of materiality benchmarks

Subtle differences are apparent in the choice of materiality benchmark between market segments and between groups of audit firms. Adjusted profit measures tend to be preferred for FTSE 100 companies and by Big 4 firms, while Challenger firms prefer the use of profit before tax as a benchmark. The relative popularity of profit measures has declined since the introduction of extended auditor reporting, with equity becoming more common over time. It has also become more common for auditors to set materiality with reference to more than one benchmark.

Auditors exercise professional judgement in selecting the most appropriate benchmark for determining materiality. This requires an understanding of the needs of the users of financial statements, as well as the nature of the company and how it is financed. **Figure 1** illustrates how the use of different benchmarks vary between FTSE 350 and large AIM companies, and between Big 4 and Challenger firms. This shows that adjusted profit measures, such as profit before exceptional items, is the most common benchmark for FTSE 100 companies. In total, 46% of reports in this segment use this measure, as do one-third of all reports issued by Big 4 firms. In contrast, profit before tax is the most common benchmark for large AIM companies (32%) and for Challenger firms (33%). Equity measures are notably more common for FTSE 250 companies, being used in 27% of reports. This reflects the greater preponderance of investment vehicles within this market segment.

Fig. 1: Materiality benchmarks by segment and firm

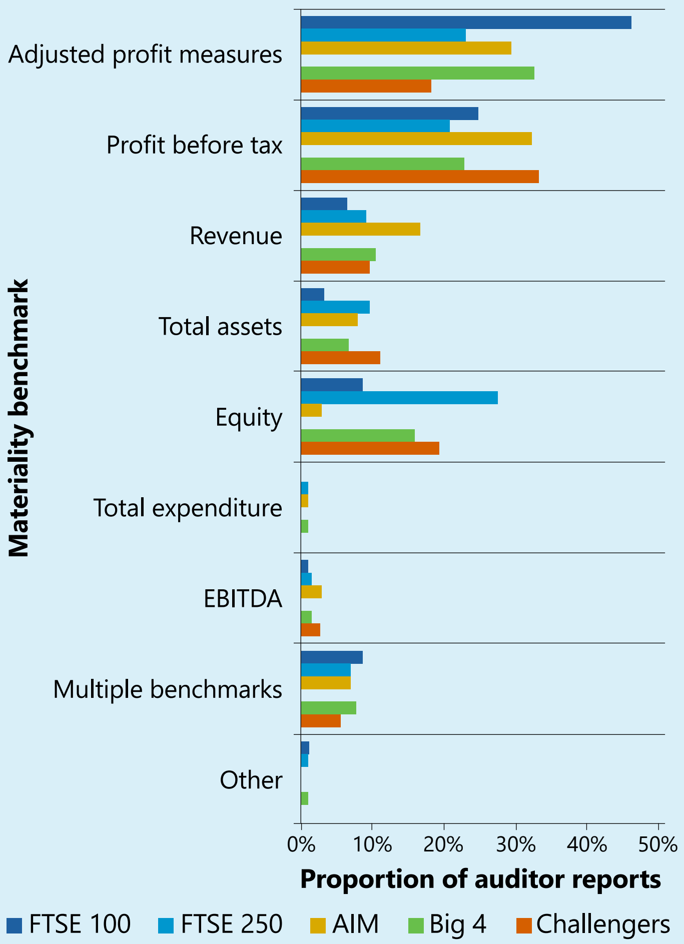


Fig. 2: Changes in materiality benchmarks over time

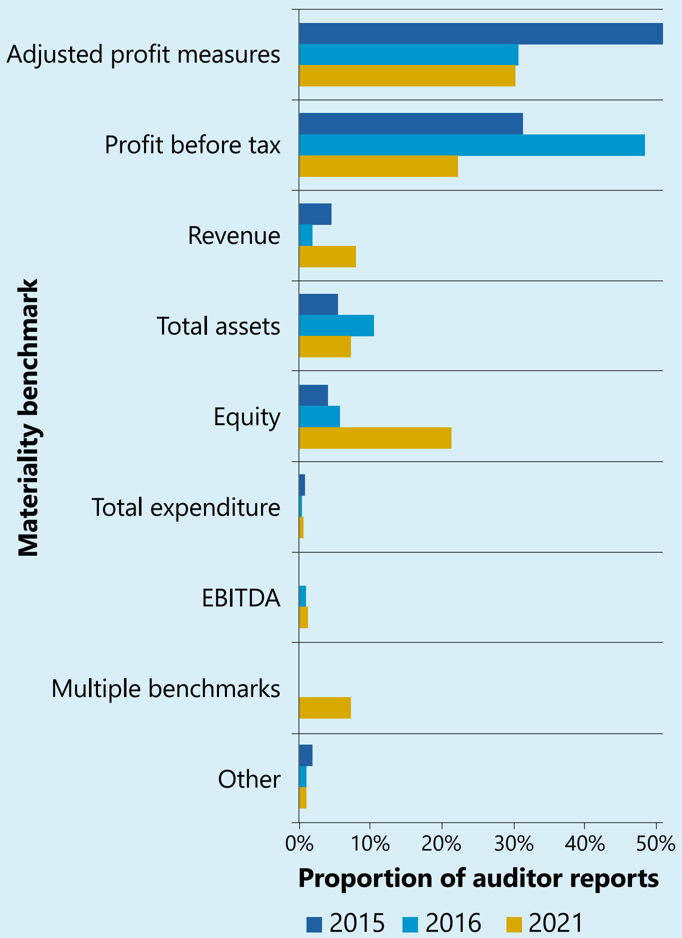
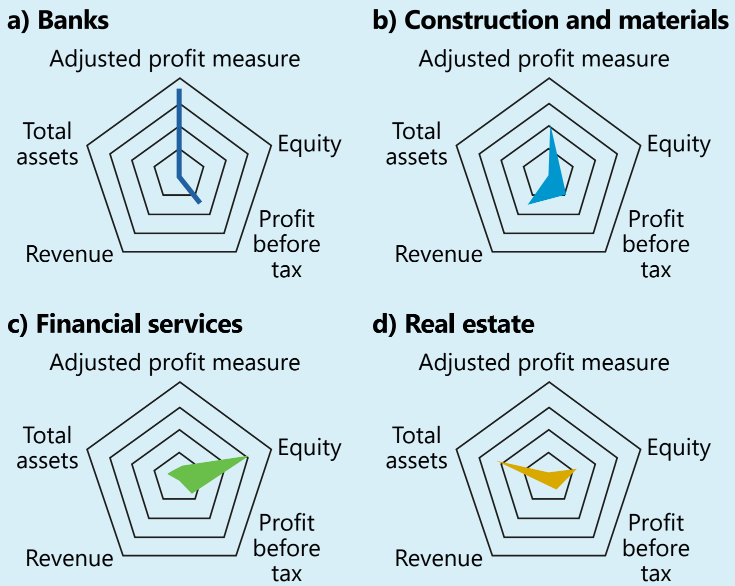


Fig. 3: Materiality benchmarks for selected industrial sectors



Findings from earlier FRC reports on auditor reporting allow a comparison of how the use of different benchmarks has changed over time **(Figure 2)**. This shows that both types of profit benchmark have become less common, while equity benchmarks have become more frequent. There has also been a growth in the number of reports which use multiple benchmarks for the determination of materiality. In these instances, a single materiality figure was selected by the auditor, which was explained with reference to several different benchmarks such as profit, equity, assets, or revenue. Most of the reports using the multiple benchmark approach were issued by a single firm.

Figure 3 shows how the use of benchmarks differed between selected industrial sectors. For banks, materiality is set with exclusive reference to profit measures. In contrast, financial services companies were likelier to have their materiality set with reference to equity. Companies engaged in construction and materials tended to have materiality based upon profit measures or revenue, while auditors of real estate companies had materiality set with reference to either equity or total assets.

3 The disclosure of performance materiality

Auditor's reports are required to report the level of performance materiality selected for the audit and disclose the judgement behind this selection. While the most used value for performance materiality was 75% of overall materiality, different firm-level approaches were observable. The propensity to describe the supporting judgement was lower for FTSE 250 and large AIM companies than was the case of FTSE 100 companies.

Performance materiality is the amount set by the auditor which is intended to reduce the probability that uncorrected and undetected misstatements exceed materiality for the financial statements as a whole. The value is less than the overall level of materiality and is expressed as a percentage of the overall materiality figure. Disclosure of performance materiality is required by the auditing standards and was included in virtually all the reports in the sample.

A description of the judgements used in setting performance materiality was also commonly included with reports **(Figure 5)**. All reports issued for FTSE 100 companies included these judgements. This information was disclosed for 96% of reports issued for FTSE 250 companies, and 82% of reports for large AIM companies. Some firms also often include 'what we mean' sections to explain performance materiality to users.

Figure 6 shows that the most common performance materiality percentage across all market segments and firms was 75% or greater. Reports issued by Challenger firms and for large AIM companies were less likely to use this value. This aggregate picture obscures differences in approach for individual firms. For example, performance materiality was set at 50% for over one third of the sampled reports issued by one firm. This explains the higher proportion of reports with a performance materiality of less than 60% for FTSE 100 companies compared to other market segments.

Fig. 6: Explaining the determination of performance materiality

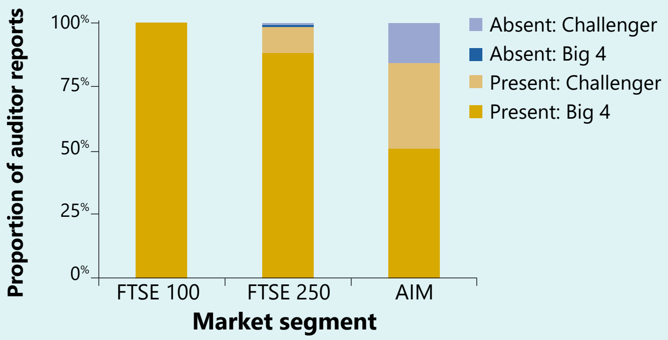
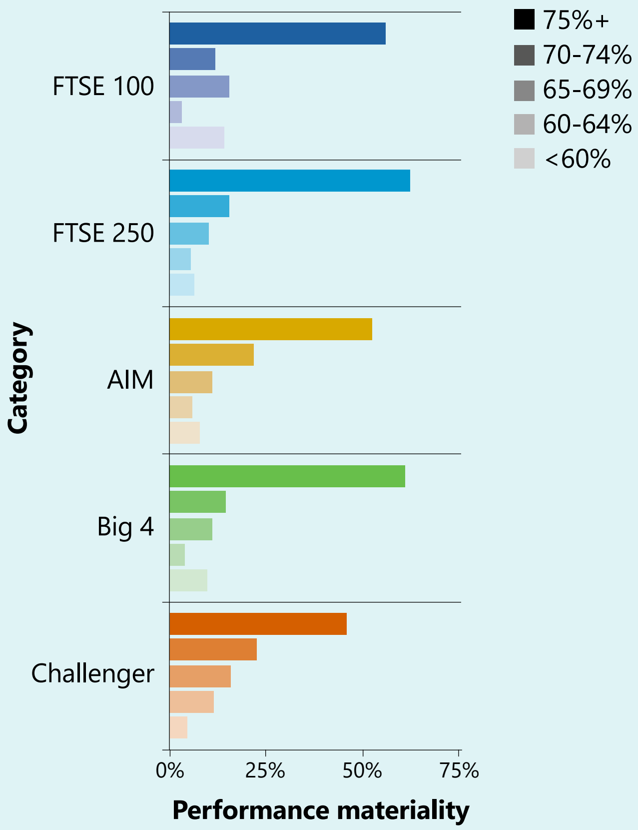


Fig. 5: Performance materiality thresholds by segment and audit firm group



4 Group audit scope and coverage

Auditor's reports frequently disclosed information on the number of components subject to group audit procedures, and the coverage achieved by these procedures over specific account balances, to satisfy the requirement to provide an overview of the scope of their audit. Firms also differed in the amount of detail provided in the report, while measures of coverage generally focused on income and profit.

A group auditor is required to provide an overview of the scope of the audit within the auditor's report. This requirement can be satisfied by discussing the effect of the group structure on scope, and the degree of coverage that audit procedures achieved. Of the 326 reports that reported group audit procedures, 92% provided a description of how many group components were in scope, and 91% provided information on the extent of coverage.

Auditor's reports often set out the numbers of components which have been subject to group audit procedures. They also routinely distinguished between components which have been subject to a complete suite of audit procedures ('full scope components'), and those where audit procedures have been performed on specific balances only. Auditors also frequently reported on the coverage achieved by these approaches. Of 214 auditor's reports which differentiated between full scope components and components where audit procedures were performed on specific balances, 59% provided information on the share of coverage achieved by these two routes. Meanwhile, 37% disclosed the overall coverage achieved without disaggregating between full scope and specific scope components, and 4% provided no information on coverage.

Auditors predominantly used measures from the income statement to describe the coverage of their audit procedures **(Figure 7)**. Revenue accounted for 34% of disclosed measures, and profit or loss after tax representing 31% of measures. The most common balance sheet measure was total assets (21%), followed by equity or net assets (at 7%). A small number of auditor's reports reported coverage of specific asset or liability balances, such as gross written premiums for insurance companies, or alternative performance measures such as EBITDA.

Figure 8 reports the average coverage achieved for each measure for the three most common measures for FTSE 100, FTSE 250 and large AIM companies. In all cases, the largest coverage was achieved for AIM companies and the least for FTSE 100 companies. This probably reflected the larger group structures of FTSE 100 companies. The coverage for total assets was also higher than for revenue, or profit or loss before tax.

Fig. 7: Measures used to quantify group audit coverage

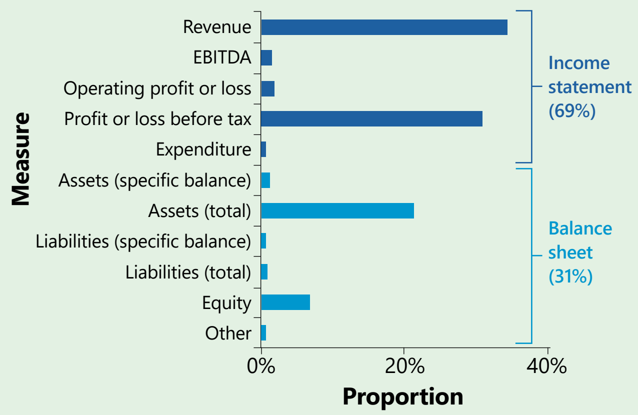
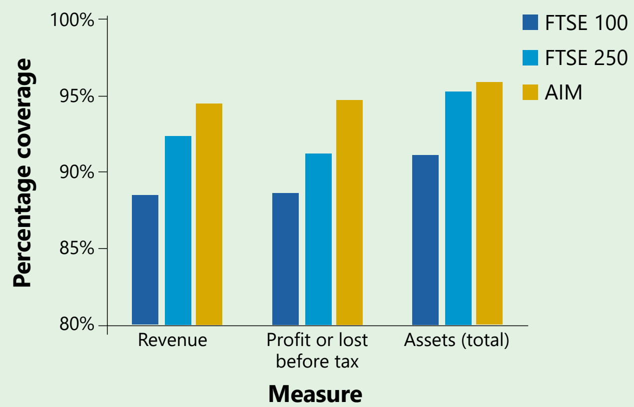


Fig. 8: Average coverage achieved by group audits for selected measures



Summary

- Profit measures remain the **most common benchmark** used for the determination of materiality. Adjusted profit measures are the most common benchmark for FTSE 100 companies, and profit before tax for AIM companies.
- However, **profit measures have become less common** since earlier FRC research into auditor reporting. The use of equity as a benchmark, as well as multiple benchmarks, have become more common.
- A high proportion of auditor reports **described the professional judgements** made by the auditor for the selection of materiality and performance materiality.
- Auditor's reports also frequently included information on the determination of which **components** were in **scope** for additional audit procedures as part of the group audit, as well as the **coverage** of specific account balances that these procedures achieved.

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Acknowledgements

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