DETERMINING MATERIALITY AND PERFORMANCE MATERIALITY - NATIONAL BANK OF BELGIUM – IREFI/IRAIF PAPER

INTRODUCTION

1. This paper deals with the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements (*Adapted from:* [ISA 320.1] Materiality in the Context of an Audit), as well as an audit of regulatory returns.

2. Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:

   - Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;
   - Judgments about materiality are made in light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and
   - Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered. [ISA 320.2]

3. Such a discussion, if present in the applicable financial reporting framework, provides a frame of reference to the auditor in determining materiality for the audit. If the applicable financial reporting framework does not include a discussion of the concept of materiality, the characteristics referred to above provide the auditor with such a frame of reference. [ISA 320.3]

4. The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements. In this context, it is reasonable for an auditor to assume that users:

   - Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;
   - Understand that financial statements are prepared, presented and audited to levels of materiality;
   - Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and
   - Make reasonable economic decisions based on the information in the financial statements. [ISA 320.4]

5. The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report. [ISA 320.5]

6. In conducting an audit of financial statements, the overall objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and to report on the financial statements, and communicate in accordance with the auditor's findings. (*Excerpt from:* [ISA 320.A1])

7. The overall objective is the same in the accredited auditor's audit of the regulatory returns and related reporting to the National Bank of Belgium ("NBB"). The exact content of the regulatory returns for institutions under supervision is described in detail in the NBB's circulars. In this paper the focus is on credit institutions incorporated in Belgium (FINREP and COREP) and insurance companies (the Solvency 2 reporting, more precisely the QRTs).

8. The audit of the regulatory returns at year-end results in the accredited auditor expressing an opinion as to whether the regulatory returns have been prepared, in all material respects, in accordance with the instructions of the NBB.

   As per the specific standard regarding the collaboration to prudential supervision (dated 8 October 2010), this audit is to be carried out in accordance with International Standards on Auditing (ISA) and the instructions of the NBB.

   Similar materiality considerations will apply to the reviews performed by the accredited auditor at half-year in accordance with ISRE 2410 (International Standard on Review Engagements 2410) to which reference is made for the half-year work on regulatory returns in the aforementioned specific standard.

9. The auditor obtains reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk. Materiality and audit risk are considered throughout the audit, in particular, when:

   - Identifying and assessing the risks of material misstatement;
   - Determining the nature, timing and extent of further audit procedures; and
   - Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in
   - forming the opinion in the auditor's report. (Excerpt from: [ISA 320.A1])

10. In planning the audit, the auditor makes judgments about misstatements that will be considered material. These judgments provide a basis for:

    - Determining the nature, timing and extent of risk assessment procedures;
    - Identifying and assessing the risks of material misstatement; and
    - Determining the nature, timing and extent of further audit procedures.

    The materiality determined when planning the audit does not necessarily establish an amount below which uncorrected misstatements, individually or in the aggregate, will always be evaluated as immaterial. The circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are below materiality. It is not practicable to design audit procedures to detect all misstatements that could be material solely because of their nature.

However, consideration of the nature of potential misstatements in disclosures is relevant to the design of audit procedures to address risks of material misstatement. In addition, when evaluating the effect on the financial statements of all uncorrected misstatements, the auditor considers not only the size but also the nature of uncorrected misstatements, and the particular circumstances of their occurrence, and the opinion in the auditor's report. (*Adapted from:* [ISA 320.6])

11. Identifying and assessing the risks of material misstatement involves the use of professional judgment to identify those classes of transactions, account balances and disclosures, including qualitative disclosures, the misstatement of which could be material (i.e., in general, misstatements are considered to be material if they could reasonablybe expected to influence the economic decisions of users taken on the basis of the financial statements as a whole).When considering whether misstatements in qualitative disclosures could be material, the auditor may identify relevant factors such as:

    - The circumstances of the entity for the period (for example, the entity may have undertaken a significant business combination during the period).
    - The applicable financial reporting framework, including changes therein (for example, a new financial reporting standard may require new qualitative disclosures that are significant to the entity).
    - Qualitative disclosures that are important to users of the financial statements because of the nature of an entity (for example, liquidity risk disclosures may be important to users of the financial statements for a financial institution).

OBJECTIVE

12. The objective of the auditor is to apply the concept of materiality appropriately in planning and performing the audit. [ISA 320.8]

DETERMINING MATERIALITY WHEN PLANNING THE AUDIT

13. When establishing the overall audit strategy, the auditor shall determine materiality forthe financial statements as a whole.

14. The auditor does not establish separate materiality amounts to individual statementsthat comprise the financial statements. [ISA 320.10]

15. The determination of materiality is not a mechanical exercise without the appropriate consideration of the facts and circumstances surrounding the audit engagement.

Use of Benchmarks in Determining Materiality

16. Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following [ISA 320.A4]:

    - The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);
    - Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);
    - The nature of the entity, where the entity is in its life cycle, and the industry and economic environment in which the entity operates;
    - The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and
    - The relative volatility of the benchmark.

17. Examples of benchmarks that may be appropriate, depending on the circumstances of the entity, include categories of reported income such as profit before tax, total revenue, gross profit and total expenses, total equity or net asset value. Profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues. [ISA 320.A5]

    When using professional judgement to set materiality, the auditor may evaluate several benchmarks to determine the benchmark considered most appropriate in the circumstances of the entity being audited. For example, the auditor may calculate various amounts using percentages of profit before tax from continuing operations, total revenue, and cash flows from operations, given that all three benchmarks are considered relevant to the users of the financial statements. Using our professional judgment based on amount that falls within the range of these various calculated amounts and based on criteria set in ISA 320.A4 (see §16 above), the auditor will determine the most appropriate benchmark.

18. In relation to the chosen benchmark, relevant financial data ordinarily includes prior periods' financial results and financial positions, the period-to-date financial results and financial position and budgets or forecasts for the current period, adjusted for significant changes in the circumstances of the entity (e.g., a significant business acquisition) and relevant changes of conditions in the industry or economic environment in which the entity operates. For example, when, as a starting point, materiality for the financial statements as a whole is determined for a particular entity based on a percentage of profit before tax from continuing operations, circumstances that give rise to an exceptional decrease or increase in such profit may lead the auditor to conclude that materiality for the financial statements as a whole is more appropriately determined using a normalized profit before tax from continuing operations figure based on past results. [ISA 320.A5]

19. When normalizing the benchmark it may be appropriate to remove the unusual circumstance from the current period results. Relevant considerations may also include the perceived needs of the financial statement users, the particular circumstances that caused the unusual results for the current year, the likelihood of their recurrence, and any other matters that, in our judgment, may be relevant in determining a normalized benchmark amount.

20. Materiality relates to the financial statements on which the auditor is reporting. Where the financial statements are prepared for a financial reporting period of more or less than twelve months, such as may be the case for a new entity or a change in the financial reporting period, materiality relates to the financial statements prepared for that financial reporting period. [ISA 320.A6] [ISA 320.A7]

21. Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment. There is a relationship between the percentage and the chosen benchmark, such that a percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue. For example, the auditor may consider five percent of profit before tax from continuing operations to be appropriate for a profit- oriented entity in a manufacturing industry, while the auditor may consider one percent of total revenue or total expenses to be appropriate for a not-for-profit entity. Higher or lower percentages, however, may be deemed appropriate in the circumstances. [ISA 320.A8]

22. When an entity's profit before tax from continuing operations is consistently nominal, as might be the case for an owner-managed business where the owner takes much of the profit before tax in the form of remuneration, a benchmark such as profit before remuneration and tax may be more relevant. [ISA 320.A9]

<u>Benchmarks for Listed companies and other Public Interest Entities</u>

23. As mentioned above the focus of this paper is on the audit of the regulatory returns of credit institutions incorporated in Belgium and insurance companies. These are Public Interest Entities just like listed entities (and some groups are also listed of course).

24. In general one would expect that profit is the main driver for Listed companies, hence that this would also be the preferred benchmark for determining materiality.

    In this context the profit benchmark used will be profit before taxes (as the corporate income tax regulation is a given) and typically any non recurring impacts will also be excluded from the benchmark amount. So for audits of listed entities in general, profit before tax from continuing operations is often a benchmark of importance to investors because earnings are used to predict future share price and the ability to pay dividends.

    For audits of listed entities, the auditor typically applies a percentage towards the lower end in the range of 5 to 10 percent of profit before tax from continuing operations to determine materiality. Other percentages may be used based on the professional judgment of the engagement leader.

25. This benchmark may also be appropriate for Public Interest Entities in general, however situations may occur for the non-listed Public Interest Entities in particular that will lead the auditor to conclude that the profit benchmark is not the most adequate. This may be the case eg when net profits are close to break-even over various years or very volatile, for entities that are not incorporated and have another main objective (eg mutualist entities), etc.

26. The following guidelines are provided to illustrate a reference point to determine the appropriate percentage to be applied to the chosen benchmark(s) to determine materiality. It is important to emphasize that these percentages are only indicative, all network of audit firms have their own specific guidance in this respect:

- 5 to 10 percent of profit before tax from continuing operations
- 1 to 3 percent of revenue
- 1 to 3 percent of total assets
- 1 to 3 percent of total equity or net assets
- 1 to 5 percent of expenses
- 3 to 5 percent of cash flows from operations.

It could be useful for the NBB to obtain on an annual basis the specific materiality considerations from each accredited auditor on each engagement of a regulated entity.

27. Some specific considerations for regulatory returns:

(1) Credit institutions incorporated in Belgium: as the complete set of FINREP and COREP regulatory returns include a.o. both balance sheet and profit and loss references, it will in general be possible to use the overall materiality as determined for the audit of the financial statements also for the regulatory returns.

(2) Insurance companies: the situation is different for the regulatory returns (QRTs) in this sector. There is no profit and loss statement in the QRTs hence it would be expected that in many instances the overall materiality applicable to the financial statements will have to be revised in the context of the regulatory returns, more specifically when that overall materiality has been determined by reference to profit before taxes.

Regarding the regulatory returns for insurance companies the focus is in the end on the validity of the solvency ratio. Following benchmarks are considered appropriate:

- the excess of assets over liabilities of the entity: as for the benchmark of total equity or net assets, a percentage in a range of 1 to 3 percent of the excess could be applied
- the solvency ratio itself: calculating a percentage of variation (upward and downward) that can be tolerated to derive a nominal amount of overall materiality

DETERMINE THE MATERIALITY LEVEL OR LEVELS TO BE APPLIED TO PARTICULAR CLASSES OF TRANSACTIONS, ACCOUNT BALANCES OR DISCLOSURES

28. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances, or disclosures. (*Excerpt from:* [ISA 320.10])

29. Factors that may indicate the existence of one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements include the following:

    - Whether law, regulation or the applicable financial reporting framework affect users' expectations regarding the measurement or disclosure of certain items (for example, related party transactions, the remuneration of management and those charged with governance, and sensitivity analysis for fair value accounting estimates with high estimation uncertainty).
    - The key disclosures in relation to the industry in which the entity operates (for example, research and development costs for a pharmaceutical company).
    - Whether attention is focused on a particular aspect of the entity's business that is separately disclosed in the financial statements (for example, disclosures about segments or a significant business combination).
    - Whether analysts' or industry reports focus on specific aspects of the entity's business or its operations (for example, restructuring activity and the entity's ability to execute restructuring plans and achieve cost savings, a litigation accrual when there have been recent legal developments at the entity). (Adapted from*:* [ISA 320.A11])

30. In considering whether, in the specific circumstances of the entity, such classes of transactions, account balances or disclosures exist, the auditor may find it useful to obtain an understanding of the views and expectations of those charged with governance and management. [ISA 320.A12]

DETERMINE PERFORMANCE MATERIALITY

31. The auditor shall determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures. [ISA 320.11]

32. Planning the audit solely to detect individually material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated, and leaves no margin for possible undetected misstatements. Performance materiality (which, as defined, is one or more amounts) is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole. Similarly, performance materiality relating to a materiality level determined for a particular class of transactions, account balance or disclosure is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in that particular class of transactions, account balance or disclosure exceeds the materiality level for that particular class of transactions, account balance or disclosure. (*Excerpt from:* [ISA 320.A13])

33. The determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by the auditor's understanding of the entity, updated during the performance of the risk assessment procedures; and the nature and extent of misstatements identified in previous audits and thereby the auditor's expectations in relation to misstatements in the current period. (*Excerpt from:* [ISA 320.A13])

34. To make a determination of performance materiality, the auditor may consider factors such as the following:

    - The auditor's understanding of the entity and its environment
    - The reliability of the entity's internal control over financial reporting (e.g., as the reliability of internal control decreases, there may be an increased likelihood of significant misstatements occurring)
    - Higher fraud risk or ineffective entity-level controls (e.g., tone at top, ineffective governance controls, competency of accounting personnel, difficulties in obtaining audit evidence)
    - Whether there is a disproportionate number of risks of material misstatement at the higher end of the spectrum (i.e., risks of material misstatement assessed as higher or significant)
    - The entity's history of misstatements, both corrected and uncorrected
    - The likelihood that misstatements from the prior period will recur in the current period
    - Management's lack of willingness to investigate and correct misstatements
    - An expected increase in accounting issues that require significant judgment and/or more judgment in estimation
    - High turnover of executive management or key accounting personnel
    - The degree of centralization and common controls/processes
    - Increased engagement risk (e.g., as a result of the entity's industry, market pressures, a potential transfer of interest in the entity, an initial audit engagement)
    - Any changes in the business that would affect our ability to forecast potential misstatements.

35. For audits of listed entities, and Public Interest Entities in general, the amount determined as performance materiality is not expected to be greater than 75 à 80 percent of materiality.

36. Even though the auditor might anticipate that he will detect no misstatements or that management will correct all misstatements, performance materiality shall be less than materiality.

37. Performance materiality is set at a lower level than materiality to reduce the risk of reaching an inappropriate audit conclusion.

38. As the aggregate of misstatements accumulated during the audit approaches materiality, the auditor is required to challenge the sufficiency of the overall audit strategy and audit plan.

ESTABLISHING A CLEARLY TRIVIAL THRESHOLD

39. The audit standards require the auditor to accumulate misstatements identified during the audit other than those that are clearly trivial. "Clearly trivial" is not another expression for "not material." Misstatements that are clearly trivial will be of a wholly different (smaller) order of magnitude, or of a wholly different nature than those that would be determined to be material, and will be misstatements that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances. When there is any uncertainty about whether one or more items are clearly trivial, the misstatement is considered not to be clearly trivial. [ISA 450.A2]

40. Up to 10 percent of materiality is often considered as clearly trivial. The engagement leader may determine, based on the facts and circumstances of the entity and the audit engagement, that a lower level is appropriate. Factors such as the nature of the entity, history of misstatements, and number of locations may affect the actual threshold of what the auditor considers clearly trivial.

41. Depending on the nature of a misstatement related to disclosures, amounts of disclosure misstatements that are quantitatively greater than what has been determined as the threshold considered clearly trivial for classes of transactions or account balances (e.g., 5 percent of materiality) may or may not be considered clearly trivial. As each disclosure in the financial statements has different characteristics, establishing a specific amount below which all disclosure misstatements would be considered clearly trivial is often not practical. Therefore, determining whether a disclosure misstatement is clearly trivial may be performed for each individual disclosure misstatement based on qualitative and quantitative considerations.

CONSIDERATIONS FOR GROUP AUDITS

42. The group engagement team shall determine the following:

- Materiality for the group financial statements as a whole when establishing the overall group audit strategy.
- If, in the specific circumstances of the group, there are particular classes of transactions, account balances or disclosures in the group financial statements for which misstatements of lesser amounts than materiality for the group financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the group financial statements, the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures.
- Component materiality for those components where component auditors will perform an audit or a review for purposes of the group audit. To reduce to an appropriately low level probability that the aggregate of uncorrected and undetected misstatements in the group financial statements exceeds materiality for the group financial statements as a whole, component materiality shall be lower than materiality for the group financial statements as a whole.
- The threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements. [ISA 600.21]

43. In the context of a group audit, materiality is established for both the group financial statements as a whole, and for the financial information of the components. Materiality for the group financial statements as a whole is used when establishing the overall group audit strategy. (*Excerpt from:* [ISA 600.A42])

44. For purposes of assessing the risks of material misstatement of the group financial statements and to design further audit procedures in response to assessed risks, the group engagement team shall determine group performance materiality to be used in the design of audit procedures at the group level.

45. To reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the group financial statements exceeds materiality for the group financial statements as a whole, component materiality is set lower than materiality for the group financial statements as a whole. Different component materiality may be established for different components. Component materiality need not be an arithmetical portion of the materiality for the group financial statements as a whole and, consequently, the aggregate of component materiality for the different components may exceed the materiality for the group financial statements as a whole. Component materiality is used when establishing the overall audit strategy for a component. [ISA 600.A43]

46. When the component is subject to an audit required by law or regulation or performed for another reason, the materiality used by the component auditor for purposes of such audit ordinarily can be expected to be less than the group materiality and, accordingly, be acceptable for purposes of the group audit. In the case of an equity method investment, the investee may be larger than the investor, and the auditor's evidence to support the investor's share of earnings from the investment may consist largely of the audited financial statements of the investee. In such cases, the materiality used by the investee's auditor may be larger than the materiality used by the investor's auditor. When such circumstances exist, the group engagement team may take into consideration matters such as the group's ownership percentage and its share of the investee's profits and losses when determining whether the component materiality used by the investee's auditor is appropriate for purposes of the audit of the group financial statements.

47. Component materiality is determined for those components whose financial information will be audited or reviewed as part of the group audit. Component materiality is used by the component auditor to evaluate whether uncorrected detected misstatements are material, individually or in the aggregate. [ISA 600.A44]

48. Where component auditors will perform an audit for purposes of the group audit, the group engagement team shall evaluate the appropriateness of performance materiality determined at the component level. [ISA 600.22]

49. In the case of an audit of the financial information of a component, the component auditor (or group engagement team) determines performance materiality at the component level. This is necessary to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial information of the component exceeds component materiality. In practice, the group engagement team may set component materiality at this lower level. Where this is the case, the component auditor uses component materiality for purposes of assessing the risks of material misstatement of the financial information of the component and to design further audit procedures in response to assessed risks as well as for evaluating whether detected misstatements are material individually or in the aggregate. [ISA 600.A46]

50. Component performance materiality shall be less than group performance materiality.

51. If a component is subject to audit by statute, regulation or other reason, and the group engagement team decides to use that audit to provide audit evidence for the group audit, the group engagement team shall determine whether:

- materiality for the component financial statements as a whole; and
- performance materiality at the component level meet the requirements of this Section. [ISA 600.23]

52. When the group engagement team requests a component auditor to perform an audit of one or more classes of transactions, account balances or disclosures the group engagement team shall determine and communicate the materiality to be used by the component auditor. In addition, the group engagement team or the component auditor shall determine the performance materiality to be used in accordance with the guidance above. When the performance materiality is determined by the component auditor, the group engagement team shall evaluate the appropriateness of the amount.

53. When the group engagement team requests a component auditor to perform specified audit procedures at a component, the group engagement team shall determine and communicate the performance materiality to be used by the component auditor.

54. Threshold for misstatements is determined in addition to component materiality. Misstatements identified in the financial information of the component that are above the threshold for misstatements are communicated to the group engagement team. [ISA 600.A45]

55. This guidance will be applicable to the audit of regulatory returns in those cases where the group engagement team decides it is required to involve component audit teams.

RECONSIDER MATERIALITY & PERFORMANCE MATERIALITY

56. The auditor shall revise materiality for the financial statements and/or the regulatory returns as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially. [ISA 320.12]

57. Materiality for the financial statements and/or regulatory returns as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances, or disclosures) may need to be revised as a result of a change in circumstances that occurred during the audit (e.g., a decision to dispose of a major part of the entity’s business), new information, or a change in the auditor’s understanding of the entity and its operations as a result of performing further audit procedures. For example, if during the audit it appears as though actual financial results are likely to be substantially different from the anticipated period end financial results that were used initially to determine materiality for the financial statements as a whole, the auditor revises that materiality. [ISA 320.A14]

58. Prior to evaluating the effect of uncorrected misstatements, the auditor is required to reassess materiality determined to confirm whether it remains appropriate in the context of the entity’s actual financial results.

59. If the auditor concludes that a lower materiality for the financial statements and/or regulatory returns as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate. [ISA 320.13]

Documentation

60. The auditor shall include in the audit documentation the following amounts and the factors considered in their determination:

- Materiality for the financial statements and/or regulatory returns as a whole;
- If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures;
- Performance materiality; and
- Any revision of (a)-(c) as the audit progressed.[ISA 320.14]

61. The auditor shall include in the audit documentation the amount below which misstatements would be regarded as clearly trivial. [ISA 450.15(a)]

Examples

62. It will be clear from the above that the determination of (performance) materiality, including of the amount below which misstatements would be regarded as clearly trivial, are matters involving significant professional judgement.

63. As examples, this document includes what could be a materiality calculation for the audit of the prudential reporting of a credit institution as well as for the audit of the regulatory returns of an insurance company. We refer to the annexes 1 and 2 to this paper for examples of the application of the materiality concept for banks and insurances' prudential reporting.

Other Considerations by the IREFI – IRAIF Board

64. Currently the NBB requires the accredited auditor to mention the level of materiality used in the audit of the regulatory returns in the reports to the NBB at both half-year and year-end.

65. The auditor may also consider applying a lower materiality for specific accounts or disclosures depending on amongst others the users' expectations. In this case, the auditor will identify the accounts or disclosures for which the applied materiality (and performance materiality) is considered as too high. This could be the case for certain reporting line items of the income statement (such as for example commission income, commission expense and personnel expense).

66. In order to further improve the NBB's information on how an auditor has determined materiality, the IREF - IRAIFI's Board suggests that the accredited auditor's reporting requirements would be increased to include at year-end an explanatory note on how materiality has been determined in the context of the audit of the regulatory returns. In accordance with the NBB circular NBB_2017_20 *Duty of cooperation of accredited statutory auditors*, the latter will take up in the prior information to be communicated to the NBB how the materiality thresholds used have been determined and how these thresholds apply to the prudential reporting.

Annexes

1. Annex 1 – Examples of materiality concept for banks' prudential reporting.
2. Annex 2 – Examples of materiality concept for insurances' prudential reporting.