Materiality Policy

POL 7/2017

Relevant Standard	ISA 320 AND ISSAI 1320
Commencement Date	21 June 2017
Review Date	The review date is 12 months after the commencement date and every three years after that.

POLICY STATEMENT

1. Intent

Auditors have to make materiality judgments on every audit. This is a difficult process as there is a no formal guidance in the auditing standards. Despite the existence of a materiality policy there has been inconsistent practice amongst the different groups in the office. In addition, the existing policy on materiality has faded in last few years and this has created a scope for inconsistent practice and calculation of materiality. One possible reason could be lack of proper guidelines.

This policy will supplement the guideline which will adequately cover the step by step guide to calculate materiality and will include all the requirements of the International standards on Auditing (ISA) 320.

The primary objective of this Policy will be to enhance consistency in application of materiality in audits across all groups and across all audits.

2. Scope

The materiality policy will be applied to all audits and includes calculation of Overall Materiality, Performance Materiality and Tolerable error.

Table 1: Overall Materiality

Benchmark	Percentage	Entities
Revenue	1 – 3	Non-profit entities
Expenditure	1 – 3	Ministry/Department
*Net Surplus	5	Profit making entities
Assets	1 - 3	Service entities Entities holding public assets

Table 2: Performance materiality

Risk	%
High Risk	40
Medium Risk	60
Low Risk	75

Misstatement Threshold/ Tolerable Error will be calculated at 5% of performance materiality.

This policy may be subject to change at the discretion of Management. However, advance notice shall be provided for any change in policy.

3. Definitions and Acronyms

Define terms used in the policy and explain any acronyms, for example:

Policy Maker	Senior Office officer responsible for Policy Development
Management	Approval of Auditor General or Deputy Auditor General

4. Policy Maker

Deputy Auditor General

5. Supporting Documents and References

International Standards on Auditing (ISA 320)

AFROSAI Audit Manual

6. Key Words

Overall Materiality

Performance Materiality

Tolerable Error

7. Monitoring

Team leaders should ensure that materiality policy is always adhered to for all audits.

Non-compliance of the policy can affect assessment of the responsible officers.

8 Supporting Procedures and Guidelines

The guidelines to the policy are attached as Annexure I to this policy. This information will provide the background to the development of the policy should Officers need clarification.

RESPONSIBILITIES	
Implementation	The Supervisors and Directors are responsible for implementing the policy.
Compliance	All staff are responsible for complying with the policy.
Monitoring and Evaluation	Quality Assurance Team will be responsible for monitoring and evaluation of the policy.
Development and/or Review	The Corporate Services division will be responsible for developing and/or reviewing the policy.
Interpretation and Advice	The Senior Admin Officer Training, Policy Development and Research/Logistics is responsible for interpreting and advising on the policy.

9 Annexure

Guideline for the policy is attached as annexure 1.

10 Approval

The materiality policy becomes effective on the date approved by the Auditor General.

11 Revision/Change Log

Version 1.0	
Policy endorsed by:	Executive Management Committee
Policy approved by:	Auditor-General
Policy effective from:	21 June 2017
Policy to be reviewed by:	21 June 2018
Manager responsible for policy:	Manager Corporate Services

Annexure 1

Materiality Guideline

This guideline compliments AFROSAI Audit Manual. It is intended to assist the auditors in calculating and applying materiality throughout the audit.

The relevant auditing standards are; ISA 320 and ISSAI 1320

SETTING MATERIALITY LEVEL FOR AUDIT:

1. During planning phase the Auditor should set Overall Materiality at a level above which misstatements either individually or in aggregate could affect decision making of the users of the financial statements.

2. The auditor should set materiality as a single amount which is set based on a benchmark which is normally an item of the financial statements.

3. In calculating and applying materiality the auditor should have a good understanding of the entity and its control environment.

SELECTION OF AN APPROPRIATE BENCHMARK FOR CALCULATION OF THE MATERIALITY

4. The Auditor should select an appropriate benchmark which will be an item of financial statements to base the overall materiality.

5. The Auditor should use one of the following relevant benchmark to base materiality:
    a) Net profit before tax – *profit making entities*
    b) Gross revenue or expenditure –*non-profit making entities/Ministries and Departments*
    c) Total assets – *entities which have custody of public assets*

6. The Auditor should always consider the following factors in selecting the appropriate benchmark:
    a) Stability, i.e.: it does not fluctuate time to time
    b) Relevance, i.e.: it is relevant to the users
    c) Predictability, i.e.: it can be predictable

7. The auditor should consider use of other items to base materiality if the most appropriate item is affected by the factors discussed in paragraph 6.

    For example if profit is volatile for a profit making entity, i.e.; it is changing most often then use of profit as a benchmark should not be considered. Instead the Auditor can use other benchmark which will be relevant and stable.

8. The Auditor must document how the benchmark was selected.

DETERMINING DATA SOURCE

9. After the Auditor has identified the appropriate item to base materiality, the auditor should determine the actual source of the data on which to calculate materiality. The auditor can select one of the following data source in preferred order:

   a) Interim financial statements
   b) Prior period financials
   c) Budgets

   The Auditor should document how data source was determined.

CALCULATING OVERALL MATERIALITY

10. The Auditor should then apply the percentage rates as specified in the “materiality scale” (*refer appendix, Table 1*) to calculate the Overall materiality.

11. The Auditor should exercise his/her professional judgment in selecting the appropriate percentage from the scale. The Auditor should have or should obtain adequate knowledge on the entity prior to exercising his/her professional judgment in determining the percentage rate.

12. The Auditor should document the reasons for the selection of the appropriate rate.

PERFORMANCE MATERIALITY

13. The Auditor should then set performance materiality which is normally less than the Overall materiality to determine the scope of substantive testing and reduce the probability of the uncorrected errors or undetected errors to exceed Overall materiality.

14. Performance materiality should be determined after assessment of Risk of Material misstatement (RMM). The auditor should (refer to Appendix, Table 2) for guidance on the percentage to be applied for performance materiality.

15. The Auditor should document the reasons for the selection of the appropriate percentage.

16. The Auditor should select all account balances above Performance materiality for audit testing.

QUALITATIVE MATERIALITY

17. The Auditor should also consider qualitative factors in determining whether accounts below performance materiality are material by nature. The auditor should select accounts which are material by nature as auditable accounts.

18. The Auditor should document the factors considered before selecting an account which is material by nature.

SPECIFIC MATERIALITY LEVELS

19. Normally Materiality is not allocated to a single component in the financial statements. In most cases there will be one materiality for the overall audit of the financial statements

20. In limited circumstances there may be different materiality level set for specific account balances. The following factors could be considered:
    - financial statements which include administered items;
    - account balances which may have problems as identified during analytical review and where a misstatement could be severe;
    - an account balance which had no problems and adjustments in prior years can be assigned a lower materiality than overall materiality as this could be cost effective; and
    - accounts which is subject to regulatory requirements

21. Where the Auditor uses different materiality levels for a specific account balance, the auditor must document the specific account balance concerned, materiality base used and materiality level obtained.

APPLICATION OF MATERIALITY

22. The Auditor should apply the materiality throughout the audit in the following manner:
    a) The Auditor should apply materiality during planning phase to determine the scope, nature and timing of audit.
    b) The Auditor should apply materiality during audit conduct to assess the misstatement.
    c) The Auditor should apply materiality during reporting to determine the impact of uncorrected errors on the audit opinion.

REVISING MATERIALITY

23. During the course of the audit conduct if the auditor become aware of circumstances which provides information which would have resulted in a different materiality if the information was provided initially then the auditor should consider the revising the materiality.

24. The auditor should also assess if the performance materiality needs to be revised and whether the test procedures for obtaining sufficient audit evidence remains appropriate.

25. If the Auditor is considering changing the materiality then the auditor should document the reason for the revision in materiality and the possible effects on the extent of the test procedures and audit evidence. This should be approved by the Audit Managers.

MISSTATEMENT THRESHOLD

26. All misstatement which is > 5% of performance materiality will be considered material and will be recorded in the Audit Adjustment sheet and will be evaluated at the conclusion of the audit against the overall materiality. Misstatements less than 5% will be considered trivial and will not be recorded.

GENERAL

27. If in any instance calculation of materiality other than what is specified above needs to be made this needs to be approved by Deputy Auditor General or Auditor General.

Appendix

Table 1: Overall materiality Scale

Benchmark	Percentage	Entities
Revenue/Expenditure	1 – 3	Non-profit entities
Expenditure	1 – 3	Ministry/Departments
*Net surplus	5	Profit making entities
Total Assets	1 – 3	Service entities Entities holding public assets

*Net surplus should not be considered if the profit is fluctuating annually or just near to break even.

Obviously the auditors will find it difficult sometimes to allocate an appropriate percentage for overall materiality.

The auditors should evaluate the following factors carefully before determining appropriate percentage for calculating the overall materiality.

- Users of the financial statements;
- Economic stability of the Industry the entity operates in; and
- Regulatory requirements
- Type of entity and nature of its operation

Table 2: Performance materiality scale

Risk of Material Misstatement (RMM)	%
High	40
Medium	60
Low	75

The Auditor should carefully understand and evaluate the risk and use professional judgment in determining the appropriate percentage for the performance materiality. In making the judgment the Auditor must evaluate the following factors in view of determining the risk of material misstatement:

Table 3: Factors for determining RMM

	Factors	High	Medium	Low
A	Overall control environment	Weak	Satisfactory	Good/Excellent
B	Financial performance	Poor	Stable	Good/Excellent
C	Accounting system	Weak	Satisfactory	Good/Excellent
D	Misstatements in prior years	High	moderate	Few/None
E	Detection or indicators of fraud	Most likely	Unlikely	Least likely
F	Expectation of misstatements in current year	High	moderate	Low

The auditor should identify and evaluate the above factors carefully before determining the Risk of Material Misstatement at the financial statements level.
Engagement Manager should make final approval on the performance materiality rate and the reasons for the selection of the rate should be documented.