Exploratory study by AFM

Materiality in the audit of financial statements

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1 Users can make more extensive use of information about materiality in taking decisions

When auditing the financial statements of a public interest entity (**PIE**), statutory auditors need to make judgements about the extent to which information in the financial statements could influence the economic decisions of users taken based on those financial statements. Under Dutch Law, the statutory auditor must disclose the materiality they applied in the audit and how they determined this materiality in the auditor's report, as well as quantitative and qualitative aspects of the materiality.[1] Users of financial statements, such as shareholders, analysts or investors,[2] can use this information in taking their economic decisions.

Through this report, the AFM shares its insights into the application of materiality in statutory audits of PIEs in the Netherlands by the 'Big Four' audit firms ('**Big Four**').[3] These insights offer starting points for a dialogue between companies' management, supervisory boards and audit committees, users of financial statements and statutory auditors about the materiality applied in audits.

Materiality is relevant to economic decisions

Information is material if its omission from or misstatement in the financial statements could influence the economic decisions of users taken on the basis of the financial statements.[4] Consequently, materiality can be relevant to users who take a decision on the basis of a PIE's financial statements, such as whether to invest in the PIE or enter into a contract with it as a client or supplier. Therefore, the judgements made by the statutory auditor and by the company's management as to what users would consider material also serve the public interest.

Users can use information about the applied materiality to determine to what extent they would consider the financial statements to be reliable. In this way, they form an opinion on whether the financial statements provide the insight they require. They can then use this in their economic decisions. Information about the applied materiality includes, for example, information about the level of detail of the audit procedures performed and the amounts and nature of corrected misstatements.

Dialogue about determination of materiality

Having a dialogue about the determination and assessment of materiality can help users to obtain relevant insights into a PIE's financial statements and can help the statutory auditor to gain a better understanding of what is important to users. To this end, users can ask questions to both the statutory auditor and to the PIE's management. For example, users can ask the statutory auditor how the materiality was determined, how the materiality was reflected in the audit procedures and what qualitative aspects were considered in this respect. They could do this at the General Meeting of Shareholders ('**GMS**'), which is an obvious occasion for users to pose such questions directly to the statutory auditor and to the company's management.

[1] Dutch Standards on Auditing *(Nadere voorschriften controle- en overige standaarden*, NV COS), Dutch Standard on Auditing 700, paragraph 29A. The references to the Dutch Standards on Auditing in this report are taken from the 2019 edition of the Accountancy Regulations Manual (*Handleiding Regelgeving Accountancy*, HRA) published by the Royal Netherlands Institute of Chartered Accountants (NBA): https://www.nba.nl/tools/hra-2019/.

[2] This can also include sector-specific users, such as supervisory and regulatory authorities and insurance policy holders.

[3] Deloitte Accountants B.V.; Ernst & Young Accountants LLP; KPMG Accountants N.V.; and PricewaterhouseCoopers Accountants N.V.

[4] Dutch Standard on Auditing 320, paragraph 2.

Materiality determines the level of detail of the audit procedures

For the statutory auditor, the materiality partly determines the level of detail of the audit procedures to be performed, the reporting to their audit client and the correction of identified misstatements by audit client's management. As such, this also relates to the quality of statutory audits. Therefore, it is a relevant aspect for the Audit Committee to consider when monitoring the statutory audit and the auditor selection process.

Materiality includes both quantitative and qualitative aspects and may differ for specific elements of the financial statements, such as for particular transaction flows, account balances or disclosures. In determining the materiality, the statutory auditor exercises judgement, such as when it comes to determining the key users of the financial statements and the relevant percentage applied to the benchmark that serves as the basis for the materiality. Consequently, different auditors may arrive at different materiality levels.

Background to this report and reading guide

The Committee of European Auditing Oversight Bodies (CEAOB), the framework for European cooperation in the supervision of audit firms, carried out a survey into the application of materiality by the Big Four. The CEAOB has also asked the Big Four about their methodologies. With the survey, the CEAOB aims to gain insight into the determination of materiality. As a member of the CEAOB, the AFM conducted the survey among the Big Four in the Netherlands in 2021. To this end, the AFM gathered information from the audit files with respect to the application of the methodology in 40 statutory audits of financial statements of PIEs.

In this report, we present the findings of the survey and explain how users can obtain insight into the materiality applied by the statutory auditor in the statutory audit. Given that the survey is an exploratory study, the AFM expresses no opinion on compliance with standards regarding materiality, nor on the quality of the relevant statutory audits.

Section 2 describes how the statutory auditor determines materiality. Section 3 describes how users can obtain insight into the materiality applied by the statutory auditor and by the company's management, and it gives examples of questions than can facilitate the dialogue between users, the audit committee, the company's management and the statutory auditor. Section 4 concludes this report with a description of the methodology used for the survey.

2 The statutory auditor determines materiality based on multiple elements

The Dutch Standards on Auditing prescribe that the statutory auditor should determine the materiality for the financial statements as a whole based on multiple elements, such as gaining insight into the needs of users and determining the relevant benchmark. During the audit, the statutory auditor should regularly evaluate whether the applied materiality is still appropriate. The auditor then determines the amount of the materiality for the financial statements as a whole by applying a percentage to a relevant benchmark. In doing so, the auditor should consider both qualitative and quantitative aspects. Examples of qualitative aspects that are relevant in determining the materiality for the financial statements as a whole are the sector, the quality of the internal control environment and whether or not the company is a new audit client. In addition, the statutory auditor may conclude that specific items in the financial statements, such as the disclosure of the board remuneration, are material due to their nature, and the auditor applies a performance materiality and a threshold for clearly trivial misstatements in the statutory audit. Furthermore, the statutory auditor may apply a lower materiality when the auditor has detected fraud. The qualitative aspect of misstatements plays a key role, given that fraud deals with intentional misstatements. Users are less likely to tolerate intentional misstatements than unintentional misstatements. Even if fraud concerns only relatively small misstatements, the statutory auditor will then make the judgement that this is likely to influence the economic decisions of users and that a lower materiality level may be appropriate for such misstatements.

In determining the materiality level (quantitative), the statutory auditor applies the methodology prescribed within their audit firm. These methodologies are based on a number of professional standards, including the following Dutch Standards on Auditing:

- Standard 320 sets out the requirements for the application of materiality in planning and performing an audit.
- Standard 450 sets out the application of materiality in the evaluation of the effect of misstatements identified during the audit, including the evaluation of the effect of any uncorrected misstatements on the financial statements.

The Dutch Authority for the Financial Markets (AFM) notes that the survey found a number of differences between the Big Four when it comes to how they determine materiality. This concerns both the methodologies of the Big Four and their application. As every statutory audit has specific characteristics, the statutory auditor’s judgement plays a key role in the determination of materiality. Consequently, the applied materiality is difficult to interpret for users. This makes it all the more relevant for users and audit committees to continue the dialogue with auditors and audit firms about the applied materiality.

Section 2.1 describes how the statutory auditor determines the materiality for the financial statements as a whole. Section 2.2 discusses how the statutory auditor can adjust the materiality. Section 2.3 describes the information that is not included in the auditor’s report, such as the performance materiality and the threshold for clearly trivial misstatements.

2.1 The statutory auditor determines the materiality for the financial statements as a whole

This materiality is based on information that is expected to influence the decisions of users

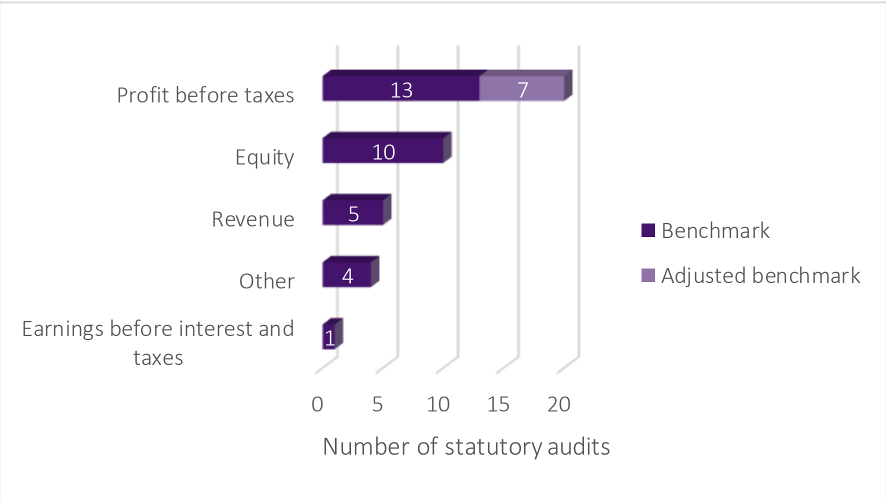
The statutory auditor considers who the key users are and makes a judgement as to what these users would consider material. The methodologies of the Big Four provide guidelines on how the statutory auditor can make a judgement regarding these users and give examples of common types of users. Critical factors include, for example, whether shares in the company are freely tradable, whether it has external financing and whether it operates in a regulated sector. In view of these factors, the auditor selects the benchmark that serves as the basis for the materiality and then applies a percentage to this benchmark that they consider appropriate.

Materiality is determined based on a benchmark

The statutory auditor selects a benchmark that the users consider critical to the view of the company's financial performance. Examples include the company's revenue, profit before taxes or equity. The methodologies of the Big Four provide guidelines on which benchmark is most appropriate depending on specific characteristics of the company, such as the sector in which it operates, its ownership structure and whether it made any profit. In determining this benchmark, the statutory auditor also considers aspects such as the nature and maturity of the company's business, as this may have an impact on whether the amount of the benchmark fluctuates over a period of multiple years.

The graph below shows the benchmarks most frequently used in the statutory audits included in the survey. Profit before taxes is the most frequently used benchmark, followed by equity. Non-recurring items, such as an impairment loss on goodwill or a restructuring of operations, may create a distorted view of the company's profit before taxes. Consequently, the statutory auditor may deem it necessary to adjust a benchmark that is based on the company's profit before taxes for these one-off items (adjusted profit before taxes).

Graph 1 Benchmarks used in the 40 statutory audits included in the survey



Profit before taxes (including variants thereof) is the most frequently used benchmark. Users of financial statements generally consider a company's profitability an important parameter.

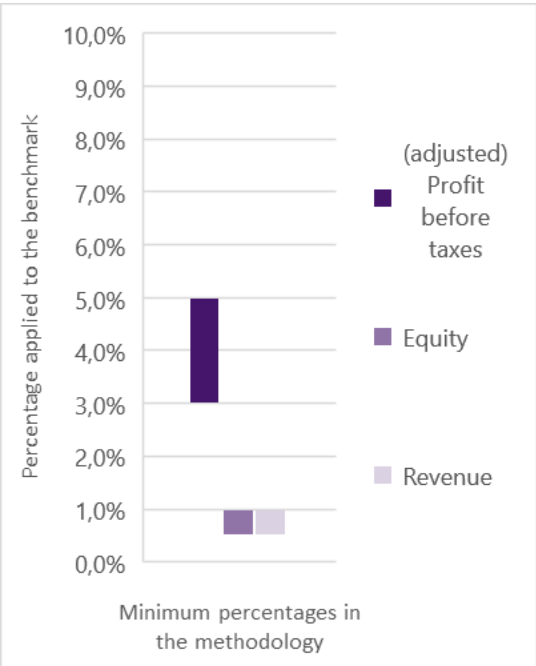
A benchmark other than profit before taxes may be more appropriate when a company turned a loss, or when it has highly fluctuating profits before taxes. For example, in the case of insurance companies, policy holders and supervisory and regulatory authorities are key users of their financial statements. They generally consider equity to be a key benchmark, as it provides insight into the company's solvency. In addition, equity is directly related to key data to be disclosed in the reporting to supervisory and regulatory authorities. The Big Four have specific guidelines on determining materiality in audits of insurance companies, including health insurers.

Materiality is calculated by applying a percentage to the benchmark

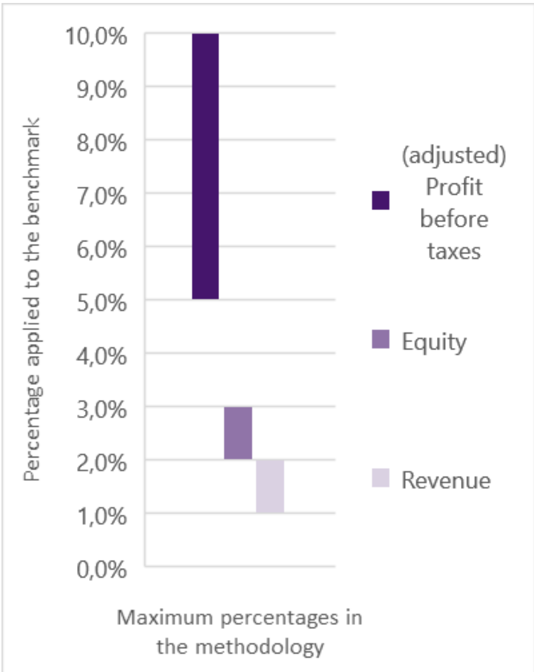
The methodologies of the Big Four prescribe which percentages should be applied to the respective benchmarks to calculate the materiality level. Usually, a percentage range is used for this, and the statutory auditor then determines the position within this range based on their judgement. At three of the Big Four audit firms, the statutory auditor determines the materiality level by applying the relevant percentage. At one Big Four audit firm, the statutory auditor determines the materiality level on the basis of qualitative considerations and then assesses whether the determined amount and percentage fit within the range. The criteria for determining the percentage are similar in all Big Four audit firms. Criteria include for example the type and number of shareholders, the stability of the company and the market it operates in, the complexity of its financial transactions and whether it has external financing.

The percentages applied to determine the materiality level varied considerably in the 40 statutory audits included in the survey. The graphs below show the minimum and maximum percentages in the methodologies of the Big Four for the three most frequently used benchmarks. The graphs illustrate that the applied minimum and maximum percentages vary among the Big Four. For profit before taxes (or adjusted profit before taxes), for example, the Big Four prescribe applying a minimum of 3% to 5% and a maximum of 5% to 10%.

Graph 2 Minimum percentages in the methodology

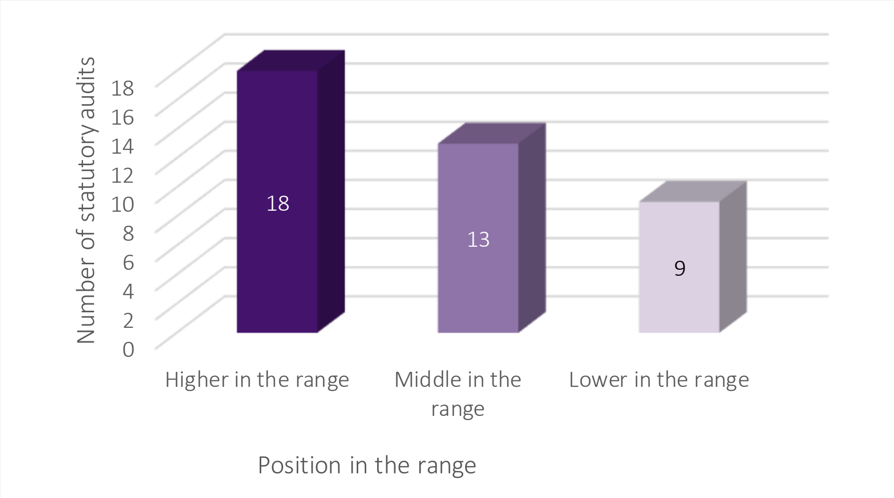


Graph 3 Maximum percentages in the methodology



The graph below shows the position in the percentage range for the statutory audits included in the survey. ‘Higher in the range’, for example, indicates that the statutory auditor applied a percentage close to the maximum percentage in the range prescribed in the relevant methodology. This was the case in nearly half of the statutory audits included in the survey.

Graph 4 Breakdown of position in the range for the 40 statutory audits included in the survey



2.2 The statutory auditor may adjust the materiality level

The statutory auditor may adjust the materiality level. At two of the Big Four audit firms, the statutory auditor may apply a percentage outside of the range prescribed in the audit firm's methodology. In addition, the statutory auditor may adjust the materiality level for specific elements of the financial statements, such as the materiality level for specific transaction flows or for reclassification misstatements.

Application of a percentage outside of the range

The methodologies of the Big Four prescribe percentage ranges for several benchmarks. The survey found that, in two statutory audits, the statutory auditor applied a percentage outside of the range based on their judgement. Consultation requirements about this vary between the Big Four.

Materiality for particular transaction flows

The statutory auditor may set a lower materiality level for one or more particular classes of transactions, account balances or disclosures. In doing so he will also take qualitative aspects into account. For example, based on legislation and regulations, the nature of an item, the fact that particular disclosures are relevant to the sector in which the entity operates or the fact that attention is focused on a particular aspect of the entity's business.[5] Therefore, in determining materiality, the statutory auditor not only needs to consider the magnitude of a possible misstatement, but also its nature. For certain items, such as the board remuneration, the statutory auditor may conclude that even small misstatements are material due to the nature of the item. It varies how this materiality level is determined. Often, a percentage is applied to the specific account balance or a fixed amount is set.

The survey found that, in the relevant statutory audits, the statutory auditors applied the materiality level for particular classes of transactions to the following items: board remuneration (including share-based payments), profit per share, cash and cash equivalents and audit fees.

Materiality for reclassification misstatements

The statutory auditor may conclude that a reclassification misstatement is not material in view of its limited impact on the financial statements as a whole,[6] given that the misstatement does not affect the balance sheet

[5] Dutch Standard on Auditing 320, paragraph 10.
[6] Dutch Standard on Auditing 450, paragraph 11.

total nor the profit/loss before tax. The survey found that, in slightly less than half of the statutory audits included in the survey, a specific materiality level was applied for reclassification misstatements. This was a higher amount than the materiality for the financial statements as a whole.

2.3 The auditor’s report provides limited information on materiality

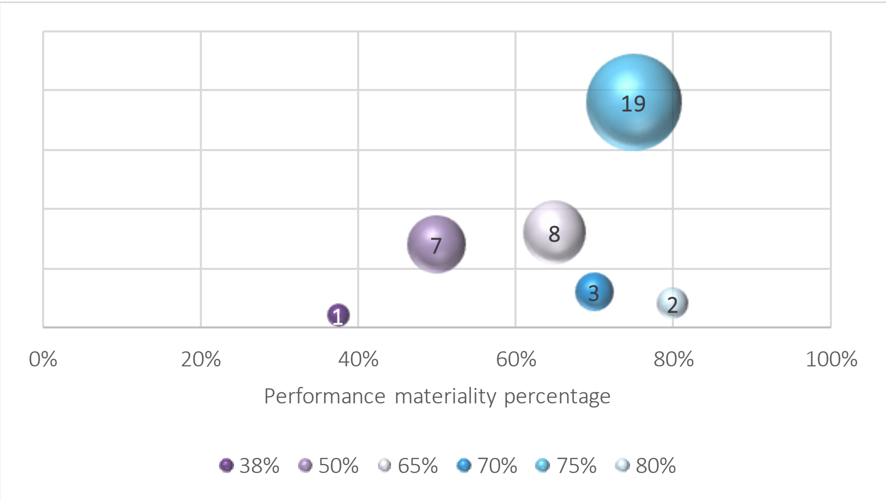
Certain aspects of materiality that can be relevant to users of financial statements, such as the performance materiality and the threshold below which misstatements are regarded as clearly trivial, are not described in the auditor’s report.

The statutory auditor applies a performance materiality

The performance materiality is the materiality level applied by the statutory auditor in the execution the audit procedures. The statutory auditor calculates the performance materiality by applying a percentage to the materiality for the financial statements as a whole. In doing so, the auditor also considers qualitative aspects that could be material.

The survey found that the performance materiality applied in the statutory audits ranged between 37.5% and 80% of the materiality for the financial statements as a whole. The most frequently applied percentage was 75%, followed by 65% and 50%. The graph below shows the distribution by frequency of the performance materiality percentages in the 40 statutory audits included in the survey. The bigger the bubble, the more often the percentage was applied. The numbers in the bubbles represent the number of statutory audits in which the specific percentage was applied.

Graph 5 Performance materiality applied in the 40 statutory audits included in the survey



At one of the Big Four audit firms, the same performance materiality percentage was applied for all the statutory audits by this firm included in the survey, with the relevant statutory auditors explaining that applying a different percentage was unnecessary. At two of the Big Four, the statutory auditors chose between a high and a low percentage. For one of the Big Four, the survey found that the applied percentages varied.

The percentages can vary because the performance materiality is influenced by a number of different factors. The survey found that, in determining the performance materiality, statutory auditors considered a number of factors, including:

- the nature and magnitude of corrected and uncorrected misstatements in prior years;
- the nature and magnitude of identified internal control deficiencies;
- the nature and magnitude of significant or other accounting estimates and accounting issues;
- the willingness of management to correct misstatements;
- the turnover rate among senior management or key personnel involved in financial reporting.

Misstatements can be clearly trivial

The statutory auditor needs to determine whether the uncorrected misstatements, individually or in the aggregate, would have a material effect on the financial statements as a whole, except for those that are clearly trivial.[7] Statutory auditors usually set this threshold amount by applying a percentage to the materiality for the financial statements as a whole.

The survey found that, in 93% of the statutory audits included in the survey, the threshold for clearly trivial misstatements was set at 5% of the materiality for the financial statements as a whole. In the other audits, this percentage varied from 2% to 10%. The methodologies of the Big Four often specify a standard percentage of 5% for the threshold. The survey found that, in determining the threshold for clearly trivial misstatements, the statutory auditors also considered the factors: corrected or uncorrected misstatements in prior years, the engagement risk and the audit client's expectations regarding the misstatements to be reported.

[7] Dutch Standard on Auditing 450, paragraph 5.

3 Users can obtain more insight into materiality

In the Netherlands, the statutory auditor is required to include information on the applied materiality in their auditor's report on the financial statements of a PIE.[8] This provides users of the financial statements of PIEs with public information on how the statutory auditor executed the audit procedures. The auditor's report gives users insight into the amount of the materiality and information on how the materiality was determined. However, certain aspects are not covered by the auditor's report. Users can compare the materiality applied in the audit by the statutory auditor with their own expectations.

Section 3.1 describes users' expectations about the materiality applied by the statutory auditor. Section 3.2 describes how users can act on the insight they have obtained and provides examples of questions that can facilitate the dialogue between users of a company's financial statements, the company's audit committee, its management and the statutory auditor.

3.1 Users form a view of the financial statements

Users form a view of the financial statements based on what they consider material in the financial statements. Information is material if its omission from or misstatement in the financial statements could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the nature or size of the information that is omitted or misstated, in light of surrounding circumstances. Users can compare the materiality applied in the audit by the statutory auditor with their own expectations.

Users can compare the insight they have obtained with their own expectations

Through the insight in the materiality applied by the statutory auditor, users of financial statements can assess whether this materiality is in line with their expectations. In addition, users gain insight into whether there are any items or disclosures in the financial statements that they consider relevant which are of lesser amounts than the materiality applied by the statutory auditor for the financial statements as a whole. Furthermore, they can gain insight into whether specific topics that they consider important have received extra attention by asking the auditor about this.

3.2 Users can take further steps based on the insight they have obtained

The company's management applies a materiality level for the preparation of the financial statements. The users of the financial statements can use the insight they have obtained in the materiality applied by the company's management and by the statutory auditor to start a dialogue.

Users can compare the insight they have obtained with the materiality applied by the company's management for the preparation of the financial statements

In addition to being a concept in statutory audits, the concept of materiality is also relevant to the preparation of financial statements. The materiality determines whether or not certain information or disclosures must be included in the financial statements. This is because accounting policies that are applicable to a specific item under International Financial Reporting Standards (IFRS) do not need to be applied when the effect of applying them is immaterial.[9] For example, omitting disclosures or incorrectly applying an accounting policy for the valuation of an asset. Therefore, a company's management makes judgements based on materiality, although there are no transparency requirements with regard to those judgements.

[8] Dutch Standard on Auditing 700, paragraph 29A.
[9] International Accounting Standard 8, paragraph 8.

A dialogue about the materiality applied by the company's management helps users to compare this to their own expectations. This way, users gain insight into whether the information that is relevant to them has been included in the financial statements or in the notes thereto.

Dialogue between users, the company's management and the statutory auditor

Users of financial statements can use the information they have obtained to ask further questions – at the General Meeting of Shareholders (**GMS**), for example, which is an obvious occasion for users to pose such questions directly to the statutory auditor and to the company's management. In addition, the audit committee could ask questions when a statutory auditor is selected.

A dialogue between the statutory auditor, the company's management, audit committees and the users can lead to more mutual understanding. In this way, the statutory auditor and the company's management can gain more insight into what is important to the users. Users can ask the statutory auditor about the applied materiality and how the materiality was reflected in the audit procedures. They can also ask the company's management about the materiality applied for the preparation of the financial statements. In addition, users could ask the statutory auditor how the materiality was determined, e.g. how the risk classification at engagement level was taken into account in determining the materiality.

Furthermore, users could ask the statutory auditor about specific topics at the GMS. Examples of such topics include particular classes of transactions, account balances or disclosures, significant revisions to threshold amounts, the amount applied for reporting uncorrected misstatements to the audit committee and significant qualitative considerations.

Below are examples of questions that can facilitate the dialogue between users, the audit committee, the company's management and the statutory auditor.

Questions for the statutory auditor

- Why did you choose the benchmark included in the auditor's report?
- Which qualitative aspects were considered in determining materiality?
- How was the engagement risk taken into account in determining materiality?
- For which particular classes of transaction, account balances or disclosures was a specific materiality level applied? Why was this applied in this manner and why was it not applied to other flows/items?
- Which elements of the financial statements are considered to be material based on qualitative factors?
- What was the performance materiality, and how did it impact the audit procedures performed ?
- What was the threshold for clearly trivial misstatements, and how was this amount determined?

Questions for the company's management

- What materiality did the company's management apply for the preparation of the financial statements?
- Which qualitative aspects were considered in the preparation of the financial statements?

4 Description of methodology

The survey was drawn up by the CEAOB, and the AFM gathered the relevant information for it. The survey questions took the form of a standard questionnaire. The results from the survey were submitted to the Big Four for factual verification and then compiled into an anonymised report that was shared with the CEAOB.

Findings based on 40 statutory audits at PIEs

Through the survey, we gathered information about the application of the methodology for determining materiality in 40 statutory audits at PIEs with the financial year 2019. The CEAOB gave instructions on the number and distribution of audits in the survey. We distributed the 40 audits to be selected among the Big Four on a proportional basis and across the following categories: listed companies, banks and insurance companies. For the banks and insurance companies, we included the determination of the materiality for the entity with a banking or insurance licence in the survey, as the methodologies of the Big Four set specific requirements for the determination thereof.

This information was gathered by accessing relevant documents concerning materiality from the respective audit files and through discussions to clarify the information received.

Survey has a number of limitations

We do not give an opinion on whether materiality was correctly determined on the basis of standards. Furthermore, we have not established whether misstatements were evaluated correctly, and we do not give an opinion on whether the application of materiality impacted the quality of statutory audits.

We have not performed statistical sampling. Therefore, the results of this survey cannot be extrapolated to all statutory audits performed by the Big Four.

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