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A Relevant Materiality Concept

Differing concepts can confuse and frustrate

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Internal auditors can be challenged in adapting or creating a definition of *materiality* that is relevant for themselves and their stakeholders. If internal auditors are not well prepared to articulate and defend what they believe to be a relevant concept of materiality, the discussion of audit issues can easily become contentious or seriously impaired. Internal auditors must fully understand the meaning and contexts of the term so they are prepared to use it authoritatively and appropriately.

Financial audit concepts

The term *materiality* arose within the context of financial reporting and assurance. The financial auditor needed to evaluate the magnitude of a misstatement (under- or over-reported amounts) or omission of a specific financial statement item in terms of its presentation and disclosure. Here, the term referred to the significance of an item to the users of a set of financial statements, and the probability that its omission or misstatement would influence or change their decisions.

Professional standards never defined the threshold for materiality as a fixed percentage of revenue, equity, or other financial statement value. Qualitative factors clearly played an equally important role as quantitative considerations. However, a widely used rule of thumb was that materiality was reached when a misstatement or omission was at least five percent of a given factor—such as net income or net

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assets. Accordingly, anything less than five percent often was considered immaterial for audit scoping or adjustment proposal purposes.

Professional guidance for auditing financial statements and their disclosures has evolved. In 1999, the U.S. Securities and Exchange Commission's (SEC's) Staff Accounting Bulletin 99 (SAB 99) rejected the blanket concept that a misstatement or omission of less than five percent of net income is immaterial. The SEC had no objection to the rule of thumb as a starting point in assessing materiality, but quantifying in percentage terms the magnitude of a financial reporting misstatement was only the beginning of an analysis of materiality.

In a determination of materiality for financial reporting, SAB 99 requires that you consider the quantitative and qualitative aspects of the matter under analysis as part of a full examination of all relevant considerations. Qualitative factors to consider in the materiality evaluation may include reaching budget or other projections, triggering or increasing executive compensation, masking a change in financial results or other trends, and achieving compliance with debt and other covenants.

Combining quantitative and qualitative factors can make the materiality determination much more complex. The result of the SEC's pronouncement was to make the old rule of thumb outdated even for financial reporting.

Before the Sarbanes-Oxley Act (SOX) of 2002, the American Institute of Public Accountants provided a definition of material weakness in internal controls over the financial reporting process. SOX guidance by the Public Company Oversight Board (PCAOB) defined material weakness differently, including three categories of financial reporting controls weaknesses based on the severity of the deficiency.

Consistent with the SEC's approach, in its standards the PCAOB avoids suggesting quantitative guidelines. The PCAOB says that materiality should not be based on a numerical formula because the facts and circumstances need to be professionally evaluated and considered for each situation.

Not surprisingly, when performing their SOX 404 assessments of internal controls over financial reporting, many organizations have difficulty in differentiating between significant control deficiencies and material weaknesses. The organizations and their external auditors often still resort to quantifiable measures of specific impact to the financial statement to help establish a distinction.

Many stakeholders, and even many internal auditors, began their careers as public accountants. Their understanding of materiality is anchored in their financial auditing and reporting experiences, but varies depending on what professional guidance was effective at that time.

Internal audit concept

Internal auditors generally refrain from the use of the term *materiality* because of its connotation with financial statements audits. *Significance* can be the substitute term of choice. More importantly, the internal audit argument against using any materiality rule of thumb is amplified by the inherent and substantial differences between the roles of internal auditors and external auditors.

Very different assurances are provided by these different services. Internal auditors review and test controls at a significantly lower level of materiality than do external auditors, and routinely review a much broader range of risks than those limited to the risk of material misstatement in financial reporting. External audits are designed to report on historical data, while internal audits are focused on the efficiency, effectiveness, and compliance of current and future operations.

Cause for confusion

Unfortunately, quantifiable rules for materiality continue to be applied to situations other than the fairness of the financial statements. Given this backdrop, the term *materiality* can be a significant cause of confusion in determining what to audit, how much to audit, what to correspondingly

Internal Audit Compared to External Audit

	Internal Audit	External Audit
Scope of work	Controls for operations, safeguarding assets, compliance and reporting reliability	Financial statements and related controls and processes
Review and testing level	Lower	Higher
Range of risks	Broad	Narrow
Time horizon	Current, with identified issues projected to future consequences	Historical data
Issue description	Nonquantifiable and quantifiable	Quantifiable
Materiality focus	Efficiency, effectiveness, competitive, customer service, regulatory, public perception, continuity, etc.	Financial reporting

report, and what is necessary to gain consensus regarding management action.

In many situations, stakeholders come to the table with their own concept of materiality—sometimes vaguely defined—that can be at odds with internal audit's definition. Sometimes managers attempt to mitigate or downplay an issue and internal audit's proposed recommendation because it reflects poorly on their performance in their respective areas of responsibility. In such instances, supposed lack of materiality is sometimes used as the basis for an argument to convince internal audit that the issue under discussion has no real merit, is insignificant, or poses a low level of risk to the organization

Internal audit professional responsibility

Internal auditors need a means of measuring, assessing, or judging the performance of a broad swath of matters that are subject to audit. In the most general sense, the standards used for this purpose are referred to as *audit criteria.* Audit criteria are reasonable and attainable standards of performance and control against which compliance, the adequacy of systems and practices, and the efficiency and cost-effectiveness of staffing activities can be evaluated and assessed.

To be realistic and useful, these criteria must be relevant, reliable, neutral, understandable, and complete. The aggregate of the internal auditor's findings measured against the criteria needs to be combined with the exercise of professional judgment. Then the audit team can form a justifiable and defensible conclusion about each audit objective. An important threshold factor is the concept of materiality.

At times, internal auditors may be inclined to avoid dealing with complex concepts of materiality and significance. They may be tempted to throw up their hands and let someone else—senior management or the audit committee—make the call on the importance of identified issues and the need for corrective action.

In this scenario, all issues would be delivered in an unfiltered and unprioritized fashion, with internal audit merely performing the role of information gatherer and reporter.

Internal auditors need to recognize **their responsibility to provide an assessment of significance.**

This approach would represent a sort of professional malpractice for many reasons, and would likely lead to key stakeholder dissatisfaction with internal audit's performance.

While internal auditors are frequently confronted with issues that defy simple categorization and prioritization, they need to recognize their responsibility to provide an assessment of significance. Internal auditors are the experts on internal controls, and that by necessity includes determining the effect that the quality of controls has on their organizations' activities.

The *International Standards for the Professional Practice of Internal Auditing (Standards)*[1] require internal auditors to add value and help improve the organization's operations. They shortchange the value proposition if they do not demonstrate how their work can directly meet these requirements. By sorting through the information they have gathered in their internal audit assignments, which necessitates the clarification of internal auditors' materiality judgments, they can move forward with the important and leave behind the unimportant.

Gray areas

Analysis and prioritization of audit results is not always an easy task. A mechanical application of a framework will not provide simple, indisputable answers. Because of the need to apply professional judgment and to consider and weigh many factors, different individuals evaluating similar facts and circumstances may reach different conclusions in certain situations. When this happens, internal auditors have to deal with the gray areas of the issue.

Some difficult issues may also need further attention to move them to consensus. You may need to engage internal or external specialists to provide subject matter expertise. Also, these very limited, infrequent, and contentious issues could be just the ones that are significant enough to require involvement by senior management or the audit committee to reach resolution.

Issues that advance to this level should meet criteria that are established and understood in advance by internal audit, senior management, and the audit committee with an agreed-upon reporting protocol. Stakeholders typically express interest in categories of topics and issues, such as fraud and significant regulatory noncompliance, or quality and effectiveness of medical care, about which they want to be made aware and involved, regardless of materiality. To cover the other possibilities needing some assessment of importance, a working definition of *materiality* is necessary for internal auditors and their stakeholders.

Professional guidance

Materiality for internal auditing was defined in a 1994 IIA research report, *The Internal Auditor's Role in Management Reporting on Internal Control*, as "any condition that has caused, or is likely to cause, errors, omissions, fraud, or other adversities of such magnitude as to force senior managers to undertake immediate corrective actions to mitigate the associated business risk and possible consequent damages to the organization."

The definition is particularly relevant because of its general management perspective, not just a financial perspective. The scope is risk-based, enterprise-wide, and action-oriented.

While the revised and updated International Professional Practices Framework[2] does not define the term *materiality*, the glossary does contain the following definition for the term *significance*: "The relative importance of a matter within the context in which it is being considered, including quantitative and qualitative factors, such as magnitude, nature, effect, relevance, and impact. Professional judgment assists internal auditors when evaluating the significance of matters within the context of the relevant objectives."

Guidelines for materiality

When evaluating the significance of the issues that your audit work identifies, some guidelines can help you supplement

[1]https://na.theiia.org/standards-guidance/Public%20Documents/IPPF-Standards-2017.pdf
[2]https://na.theiia.org/standards-guidance/Pages/Standards-and-Guidance-IPPF.aspx

the definition, frame the evaluation and determine significance. These guidelines help with the application of materiality in practice. Also, you can also use them to inform, educate and achieve conceptual consensus with your stakeholders.

Materiality for external auditors may not be relevant – Do not base materiality for matters of operational efficiency and effectiveness, safeguarding assets, and compliance with laws and regulations on the materiality concepts and levels considered by the external auditors. External auditors provide very different assurance for purposes of the examination of the financial statements or the SOX 404 internal control assessment.

Incorporate contextual considerations – You should never use materiality as a sole or significant measure for prioritization and investigation in cases of suspected or illegal behavior or fraud. Put another way, zero tolerance or allowable error of zero should be established when considering illegal acts.

Consider qualitative factors – The qualitative dimensions of an issue may be more important than the quantitative aspects. Patient service, public perception, cycle time, quality outcomes, and employee morale are examples of important considerations that are resistant to quantification efforts.

Context matters – Remember that not all quantifiable areas are the same. For example, the significance of errors and misstatements will be different for suspense accounts and related-party transactions because they involve greater risk than most other accounts or activities with similar balances.

Is the issue pervasive or isolated? – Understand the root cause of the issue. The fact that it has or can easily recur justifies more concern than an isolated, explainable, one-time matter.

Improve performance – Lost opportunities to quantifiably enhance revenues and reduce and avoid costs, while not technically material or relevant to the current financial statements, can be materially important, and have a cumulative effect in improving performance in future periods.

Summary

Internal auditors need to understand the professional background and experiences of stakeholders with materiality concepts. A foundation of dialogue with your stakeholders can help you mutually agree upon a framework based on quantitative and qualitative factors. Giving meaningful context to the reporting of issues can enhance your value to your organization and help stakeholders in establishing priorities, deciding remediation, and escalating issues when necessary. DI

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