COMMITTEE OF
EUROPEAN
AUDITING
OVERSIGHT
BODIES

REPORT ON THE CEAOB SURVEY

MATERIALITY IN THE CONTEXT OF AN AUDIT

JULY 2022

Preamble: objective of the survey

One of the key objectives of an auditor in conducting an audit of financial statements ("FS"), is to obtain reasonable assurance about whether the FS as a whole are free from material misstatement, whether due to fraud or error.

The concept of materiality is thus fundamental in the context of an audit. There are however several questions which remain open for clarification. For instance, what does a material misstatement mean? How does the auditor exercise professional judgment to assess the audit materiality? Or how does this assessment impact the scope of the audit work?

Considering the above, the Committee of European Auditing Oversight Bodies ("CEAOB") carried out a survey in 2020 and 2021, which pursued the following objectives:

1. Explaining the concept of audit materiality and how it impacts an audit
2. Analyzing how the Big 4 audit firms and their audit methodologies help in exercising professional judgment in a consistent manner
3. Investigating how the concept of materiality is applied in practice by the BIG 4 firms on a sample of audits of Public Interest Entities ("PIE"), and
4. Collecting the views on materiality for a sample of Audit Committee Chairs ("ACCs") to see the potential convergences or divergences with those of auditors.

Methodology of the survey

The first objective is targeted towards non-practitioners and aims to explain in simple words with the recourse of concrete examples the notion of materiality and its application on an audit. The elements used are based on ISA literature and especially ISA 320 "*Materiality in planning and performing an audit*".

To achieve objectives #2 to #4 listed above, the CEAOB developed three questionnaires:

- Questionnaire 1: distributed to Big 4 networks and dedicated to collect information on their methodologies on materiality, applicable at the time of this survey *(refer to Section 3)*;
- Questionnaire 2: capturing the application by Big 4 auditors of the methodologies, guidance and concepts on a sample of PIE audits *(refer to Section 4)*;
- Questionnaire 3: addressed and filed in on a voluntary basis by a sample of ACCs (comprising PIE sample of Q2). It captured their views on audit materiality and the way materiality is discussed with the auditor *(refer to Section 5)*.

This publication is based on the input received from participants to this survey. As further disclosed in the Report, the coverage reached, in terms of PIE audits and audit committees enables a fair analysis of how auditors of Big 4 firms assess materiality in practice on their PIE audit engagements and how audit materiality is perceived by audit committees. However, as our sample is not statistical, our results and observations cannot be extrapolated.

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1. Executive summary

Assessing the appropriate materiality levels is a fundamental decision for an audit engagement as it drives the scope, nature and extent of the procedures performed by the auditors. It cannot be reduced to a simple mechanical task and requires professional judgment in considering all relevant facts and circumstances, including qualitative aspects, with due care.

The CEAOB survey on materiality, the scope of which is summarized below, provides a good overview of how Big 4 Firms determine materiality levels and how Audit Committee Chairs perceive this assessment and interact with auditors on materiality matters.

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4 objectives covered

4 audit methodologies and guidance from Big 4 Firms scrutinized

495 PIE audits across 21 EEA countries observed

247 Audit Committee Chairs surveyed from 15 EEA countries

If similarities between audit firms and audit committees were observed, some discrepancies and inconsistencies which are worth further consideration were noted. Therefore, in order to enhance the appropriateness of assessed materiality levels made by auditors, to prevent judgmental biases and to limit the source of discrepancies that may arise, recommendations made include the following:

While recognizing the fundamental role of judgment in assessing audit materiality, **standard setters** may enhance the requirements on audit materiality by:

- Providing application materials and/or illustrative examples regarding the ranges of percentages that could be applied by the auditors to the most frequently used benchmarks for PIE audit engagements;
- Supporting auditors with an application guidance for the determination of the overall materiality percentage within a range, including for instance relevant indicators when using a percentage higher or lower in such range;
- Establishing minimal rules for assessing performance materiality (for example the introduction of specific requirements for the "haircut" to be applied and the development of specific considerations for first year audits);
- Considering for PIE audits the disclosure of overall materiality and its assessment basis not only in the additional report to the audit committee but also in the audit report.

Auditors need to stand back and may reconsider certain aspects of their practice when assessing audit materiality by:

- Paying greater attention to the needs of financial statements' users when identifying the most relevant benchmark applicable to the audited entity, being sensitive to the key metrics and drivers they are following (e.g. EBITDA, Return on Equity...);
- Challenging current methodology and guidance for assessing materiality for PIE audits, considering best-practices observed at peers;
- Reconsidering the appropriateness of "Total assets" as the relevant benchmark when auditing a credit institution or an insurance company;
- Favouring the use of higher "haircuts" for assessing performance materiality when working on a first-year engagement;
- Having a closer look at the consistency of assessments made between engagement risks and materiality;
- Carefully assessing the circumstances when specific materiality of a lesser amount for particular classes of transactions, accounts or disclosures needs to be determined.

Audit committees need to enhance dialogue with auditors on materiality matters, taking even further steps when appropriate by:

- Sharing their views on the main key performance indicators relevant to the situation and discussing contradictions, if any, with the benchmark selected by auditors for determining the overall materiality;
- Challenging with due care the appropriate overall materiality percentages assessed by auditors. To this end, audit committees may consider enhancing their expectations, carefully assessing the amount of an omission or misstatement that could influence the economic decisions of the financial statements' users;
- Paying attention to particular classes of transactions, account balances and disclosures, for which a specific lower materiality would be expected;
- Putting more emphasis on the materiality level in the auditors' selection process and assessing the impact of the materiality determined on the audit scope and insofar on the audit quality.

2. Materiality and its impact on an audit

2.1. What is Materiality?

The concept of materiality recognizes that some matters are more important for the fair presentation of the FS than others are. In performing the audit, the auditor is concerned with matters that, individually or in aggregate, could be material to the FS.

The auditor's responsibility is to conduct an audit of the entity's FS in accordance with ISAs. To this end the auditor has to "obtain reasonable assurance about whether the FS 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 FS are prepared, in all material respects, in accordance with an applicable financial reporting framework"[1].

Materiality is not only relevant for an audit but also for financial reporting. This is why ISA 320 notes that the frame of reference in determining the materiality for an audit is provided above all in the applicable financial reporting framework. Although financial reporting frameworks may discuss materiality in different terms[2], they generally explain that:

Frame of reference in determining materiality [ISA 320.2]	**Misstatements and omissions are considered 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 FS**.
	Judgment 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
	Judgment about matters that are material to users of the FS 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.

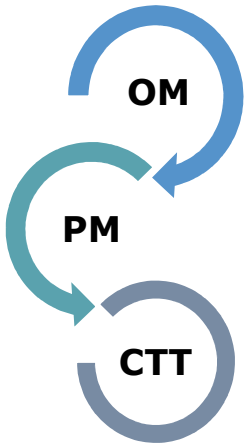
Whereas audit materiality is always represented by a figure, qualitative aspects surrounding its determination remain essential. In addition, it applies also to all types of disclosures, including non-quantified information.

Therefore, while this survey focusses on many instances on figures and percentages, it is important that the reader keeps in mind that these amounts are always closely related to specific qualitative features suitable to the facts and circumstances of the audit engagement.

[1] [ISA 200.11]
[2] See for instance the definition of the materiality given in §7 of IAS 1 "Presentation of Financial Statements" and in §5 of IAS 8 "Accounting policies, Changes in Accounting Estimates and Errors". If the applicable financial reporting framework does not include a discussion of the concept of materiality, the characteristics referred to above (as per ISA 320.2) provide the auditor with such a frame of reference [ISA 320.3].

2.2. How materiality impacts the audit?

Applying the concept of materiality in audit requires the auditor to determine various amounts including the materiality for the FS as a whole (referred as the overall materiality or "OM"), the performance materiality ("PM") and to set a "clearly trivial" threshold ("CTT").



Overall materiality is the maximum amount of an omission or misstatement that, individually or in the aggregate, could reasonably be expected to influence the economic decisions of the FS users.

Performance materiality is used to assess risks of material misstatements ("RoMM") and to determine the nature, timing and extent of the audit procedures.

"Clearly trivial" threshold is intended to help the auditor to identify and accumulate misstatements identified during the audit, other than those that are clearly trivial.

2.2.1. Impact of the Overall Materiality

OM fulfills two primary objectives[3]:

1. OM is set at planning stage by the auditor and serves in the determination of the **overall audit strategy**. Making judgments about the size of misstatements that will be considered material provides a basis for:
   - determining the nature, timing and extent of risk assessment procedures; and
   - concentrating the engagement team's efforts on significant matters.

2. OM is considered by the auditor in evaluating the effect of uncorrected misstatements, if any, on the FS and **in forming its audit opinion**.
   In assessing whether misstatements are material, the auditor needs to consider both the size and the nature of those misstatements.

Illustrative example: a non-pervasive judgmental misstatement amounting to M€ 25.0 was identified during the audit. This misstatement is the only one identified by the auditor. Management disagrees with this audit misstatement and does not want to adjust the FS. Depending on the amount of overall materiality assessed by the auditor, the incidence on the audit opinion would be as follows:

OM assessed at M€ 30.0	**OM assessed at M€ 20.0**
The misstatement is below OM. The auditor issues an **unmodified opinion** (i.e. *the FS present fairly, in all material respects, the financial position of the Company as at YE (N) and its financial performance and its cash flows for the year then ended in accordance with the applicable financial reporting framework*) and reports uncorrected misstatements to Management and TCWG.	The misstatement is above OM but not pervasive. The auditor issues a **qualified opinion** (i.e. *except for the identified misstatement described in the audit report, the FS present fairly, in all material respects, the financial position of the Company as at YE (N) and its financial performance and its cash flows for the year then ended in accordance with the applicable financial reporting framework*)

The OM is also used by the auditor to set PM as well as the CTT for accumulating misstatements. Both are in effect expressed as a percentage of the OM.

[3] [ISA 320.5]

2.2.2. Impact of the Performance Materiality

Irrespective of the influence the use of data analytics[4] may have in the audit work, PM remains key for identifying and assessing the RoMM and for determining the nature, timing and extent of further audit procedures. This amount is set below OM to reduce to an appropriately low level, the probability that the aggregate of uncorrected or undetected misstatements in the FS exceeds OM. In other words, it provides a buffer to the auditor for any possible undetected misstatements and helps him or her in reducing to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the FS exceeds OM[5].

Depending on the facts and circumstances of the audit engagement, this buffer will need to be more or less significant. An inadequate assessment may therefore trigger insufficient audit procedures, as evidenced in the below illustrative examples:

a) Examination of accounts, classes of transactions ("CoTs") and disclosures:

PM primarily affects the identification of the account balances, CoTs and disclosures, the auditor plans to select for examination:

Illustrative example: based on the understanding of the entity and its environment as well as on the experience gained from prior audits, the auditor determined PM to be M€ 16.9 which is 75% of OM (M€ 22.5). The audit response from the auditor to an account balance such as "Other debtors" may vary as follow:

Account balance: **M€ 15.0**	Account balance: **M€ 25.0**
In the absence of any other identified risk factors, the auditor might not design and perform any audit procedures to cover the other debtors balance if there is no RoMM.	Other debtors represent a material account balance. Irrespective of the assessed RoMM, ISA 330.18 requires the auditor to perform substantive procedures as it exceeds OM.

b) Determination of audit samples:

PM serves often also for determining the tolerable misstatement[6] level for audit sampling applicable to substantive audit procedures and accordingly affects the size of certain audit samples. A reduced level of PM requires a larger sample size to reduce the sampling risk as illustrated below:

Illustrative example**:** let's consider the following formulas for determining the sample size in a homogeneous population:

- Sampling Interval = (Tolerable Misstatement – Expected deviation) ÷ Confidence Factor
- Sample Size = Population to be tested ÷ Sampling Interval

Considering the above formula with a population to be tested of M€ 200, an expected deviation of M€ Nil, a confidence factor of 2 and a tolerable misstatement set as PM, the sample size is:

Tolerable Misstatement **M€ 5.0**	**Tolerable Misstatement** **M€ 10**	**Tolerable Misstatement** **M€ 15**
Calculated sample size = **80 items to be tested**	Calculated sample size = **40 items to be tested**	Calculated sample size = **27 items to be tested**

[4] In certain situations, data analytics techniques may enable, when adequately performed, the substantive testing of the entire population of CoTs, eliminating any sampling risk or aggregation risk. The incidence of PM on the audit and on the nature, timing and extent of further audit procedures, may therefore be significantly impacted in these instances.

[5] "[ISA 320.A13]: 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.

[6] "[ISA 530.A3]: When designing a sample, the auditor determines tolerable misstatement in order to address the risk that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and provide a margin for possible undetected misstatements. Tolerable misstatement is the application of performance materiality, as defined in ISA 320,2 to a particular sampling procedure. Tolerable misstatement may be the same amount or an amount lower than performance materiality."

c) Performance and results of substantive analytical procedures:

Finally, PM influences the threshold the auditor uses, when performing substantive analytical procedures (ISA 520.A16)[7] as well as the extent of the procedures performed.

Illustrative example: the engagement team developed a substantive analytical procedure for reviewing the accuracy of the total payroll costs for the period, which amount to M€ 80. The auditor's expectation, based on the previous audited figures adjusted by i) the known increase of the number of employees and ii) the indexation of the salaries, amounts to M€ 81.8.

The results of the procedure performed are therefore detailed as below:

- Payroll costs (current balance): M€ 80.0
- Payroll costs (auditor's expectation): M€ 81.8
- Difference with the expectation: M€ 1.8

The auditor decides to use the assessed PM for the purposes of the investigation threshold.

Let's consider the following two scenarios, where PM amounts to either M€ 2.0 (scenario a) or M€ 1.5 (scenario b).

Scenario a: **PM = M€ 2.0**	Scenario b: **PM = M€ 1.5**
The amount of difference from the expectation is below the threshold, therefore the auditor can positively conclude on the procedure performed **without additional investigation.**	The amount of difference from the expectation exceeds the threshold, therefore the auditor cannot directly conclude on the procedure performed and **has to perform additional investigation.**

2.2.3. Impact of the Clearly Trivial Threshold

The auditor sets CTT at an amount below which misstatements of amounts, would not need to be accumulated, because s(he) expects that the accumulation of such amounts would clearly not have a material effect on the FS.

Misstatements of amounts that are above the designated amount are accumulated (as required by ISA 450.5[8]). They can also be distinguished between factual misstatements, judgmental misstatements and projected misstatements.

If there is any uncertainty about whether one or more items are clearly trivial, the matter shall be considered by the auditor not to be clearly trivial.

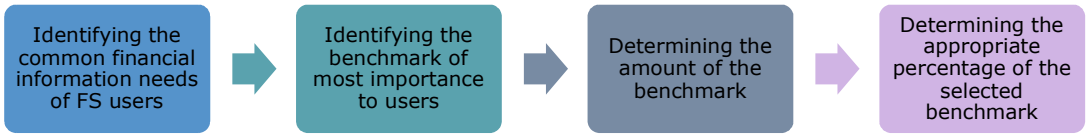
[7] "[ISA 520.A16]: The auditor's determination of the amount of the difference from the expectation that can be accepted without further investigation is influenced by materiality and the consistency with the desired level of assurance, taking account of the possibility that a misstatement, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated."

[8] "[ISA 450.5]: The auditor shall accumulate misstatements identified during the audit, other than those that are clearly trivial."

3. Determining materiality (in theory)

3.1. Determining Overall Materiality

Typically, auditors go through the following steps when establishing their overall audit strategy and assessing OM for a particular engagement:



3.1.1. Identifying the common financial information needs of FS users

Assessing materiality assumes the auditor being able to determine the amounts above which the decisions taken by FS users would be influenced or changed. Therefore, the auditor shall first identify the FS users and their needs. In applying his or her professional judgment, the auditor assumes that the FS users:

Assumed characterstics of FS users [ISA 320.4]	Have a reasonable knowledge of business, economic activities, and accounting, and have a willingness to study the information in the FS with reasonable diligence;
	Understand that FS are prepared 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 on the basis of the information in the FS.

3.1.2. Identifying the benchmark of most importance to FS users

ISA 320 provides limited guidance to assist the auditor in identifying the benchmark of most importance to FS users. Indeed, apart from listing a number of factors to consider in its identification (refer to below extract), the standard merely states that profit before tax from continuing operations ("PBTCO") is often used for profit-oriented entities and that when PBTCO is volatile, other benchmarks may be appropriate, such as gross profit or total revenues[9].

Factors which may influence the identification of a relevant benchmark [ISA 320.A3]	Elements of the FS (e.g. assets, liabilities, equity, revenues, expenses)
	Whether there are items on which the attention of the users of the particular entity's FS tends to be focused (e.g. for the purpose of evaluating financial performance, users may tend to focus on profit, revenue or net assets)
	Nature of the entity, where the entity is in its life cycle, and the industry and economic environment in which the entity operates
	Entity's ownership structure and the way it is financed (e.g. 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)
	Relative volatility of the benchmark

[9] "[ISA 320.A5]: 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."

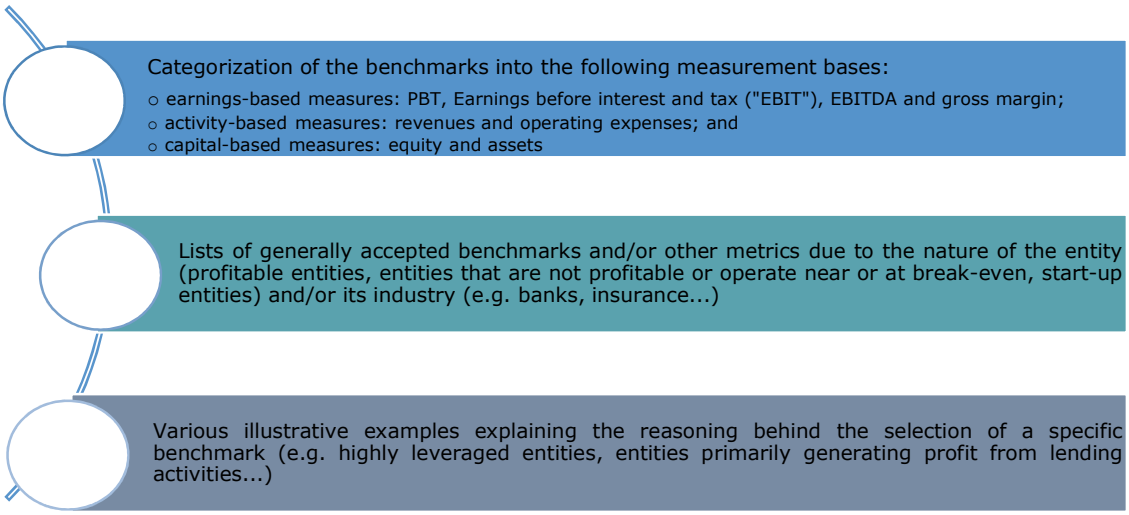
To remediate this lack of guidance in the ISAs, Big 4 firms have developed detailed internal materials to assist practitioners to identify the relevant benchmark based on the facts and circumstances of the audit engagement. These internal firm's guidelines help to drive consistency in their audit practice.

First of all, a broadly shared guideline consists of giving a preference for an earnings-based benchmark (like Profit before tax ("PBT") or PBTCO) for equity issuers.

Indeed, it can reasonably be assumed that the primary users of FS are shareholders and potential investors and that the main decisions taken by these FS users are to purchase, sell or hold their investment in these entities. The stock price being a key element in this decision-making process, identifying the financial metrics which most influence the stock price is fundamental in establishing the materiality.

Looking at the key performance indicators ("KPI") regularly published by the issuer and at the main drivers monitored by financial analysts (e.g. Earnings per share ("EPS") or Earnings before interest, tax, depreciation and Amortization ("EBITDA")) helps in finding the relevant benchmark, on which to base the materiality. Except for particular situations (like start up entities or entities experiencing losses), the operating performance of the entity and an earnings-based benchmark (like PBT or PBTCO) will be the most relevant metric to consider for equity issuers. Although not stated in ISA 320, this presumption is clearly embodied in each Big 4 firm methodology.

Other constructive elements observed in this regard in the firms' methodologies include the following:



3.1.3. Determining a value for the selected benchmark

Determining a value for the benchmark is not always straightforward, not only because this exercise may require to adjust or "normalize" the amount for any specific non-recurring situations or events[10], but also because the preliminary assessment is made at an early stage in the audit process.

It may therefore need to use forward-looking information or extrapolation.

Obviously, as the audit progresses, the auditor needs to reconsider the preliminary amount determined, in case of change in the circumstances or new information.

[10] "[ISA 320.A6]: 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."

3.1.4. Determining the appropriate percentage of the selected benchmark

ISA guidance is rather limited with regard to the percentage to be applied by the auditor to a chosen benchmark.[11]

This gap is however addressed in the Big 4 firms' audit methodologies. Indeed, firms have developed quantitative and qualitative guidance for helping their auditors to determine the percentage to be applied against a selected benchmark in a consistent manner.

These guidelines always include an illustration of presumed[12] reasonable ranges of percentages to be applied to a chosen benchmark.

Although one may question the appropriateness of such guideline, all 4 firms except Firm C provide two clear separate ranges: (i) one for listed entities and PIEs (incl. entities in regulated industries) and (ii) one for the other entities.

The firm using common ranges for both PIEs and non-PIEs audit engagements has the highest upper percentages (as compared to the ranges applicable only for PIE audits of the other three firms) for the 5 common observed benchmarks illustrated below.

Overview of % ranges to be applied to certain common benchmarks observed at Big 4 firms for PIEs audit

	Earnings-based measures		Activity and capital-based measures		
	PBT / PBTCO	EBITDA	Revenue	Equity or net assets	Total assets
•**Firm A**	• 5% to 8%	• 2% to 3%	• 0.5% to 1%	• 1% to 2%	• 0.5% to 1%
•**Firm B**	• Up to 5%	• Up to 2.5%	• Up to 1%	• Up to 1%	• Up to 1%
•**Firm C**	• 5% to 10%	• 3% to 5%	• 0.8% to 2%	• 1% to 3%	• 1% to 2%
•**Firm D**	• 3% to 5%	• -	• 0.5% to 1%	• 0.5% to 2%	• 0.5% to 1%

The absence of guidance in the standards may be one of the reasons of the large variances observed in percentage ranges between the Big 4 firms. We will see in section 4 if these variances have an influence on the observed OM percentages when analyzing the results of our PIE audits' sample.

In addition to the above, Big 4 firms also provide practitioners with qualitative factors for assessing the appropriate level of a chosen benchmark.

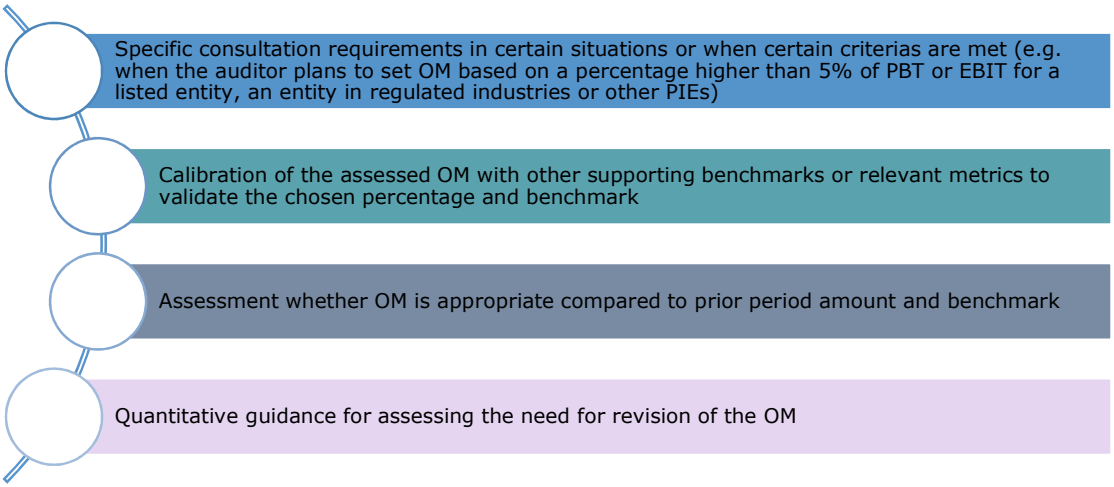
[11] "[ISA 320.A8]: For example, the auditor may consider five percent of profit before tax from continuing operations to be appropriate for a profit-oriented entity in manufacturing industry, while the auditor may consider one percent of total revenue or total expense to be appropriate for a not-for-profit entity. Higher or lower percentages, however, may be deemed appropriate in the circumstances."

[12] Ranges given in the methodologies are rebuttable and auditors still have the possibility, where deemed appropriate, to use a percentage outside the firm's range.

Among the factors, the presence or absence of which will influence the percentage retained, we can notably quote the following:

- the business environment of the entity (stable vs volatile; viable vs eroding);
- the debt arrangements (traded debt or covenants);
- the consideration of specific factors (e.g. the entity operates in a highly regulated industry);
- the relative sensitivity to changes (e.g. where small changes in the earnings may have limited vs significant impact on users);
- the wide vs limited distribution of, or use of, the FS;
- the ranges used by analysts as well as market reaction to a profit warning.

Beyond these qualitative and quantitative guidelines, the following requirements or guidance observed at some Big 4 firms' merit being mentioned:



3.1.5. Specific materiality of a lesser amount

The auditor shall also determine if there are one or more particular CoTs, accounts balances or disclosures for which misstatements of a lesser amount than OM could reasonably be expected to influence the economic decisions of FS users[13]. This could relate to sensitive areas such as particular disclosures like management remuneration or EPS, or the compliance with legislation or certain contracts (e.g. bank covenants).

To perform this assessment, the standard provides certain factors to be considered by the auditor as shown in the below extract:

Factors which may indicate lower materiality levels for particular CoT, account balances or dsclosures [ISA 320.A11]	Whether law, regulation, or the applicable financial reporting framework affect user's expectations regarding the measurement or disclosure of certain items (e.g. related party transactions, remuneration of management and TCWG 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 (e.g. R&D costs for a pharmaceutical company)
	Whether attention is focused on a particular aspect of the entity's business that is separately disclosed in the FS (e.g. disclosures about segments or a significant business combination)

[13] "[ISA 320.10]: 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, accounts balances or disclosures."

3.2. Determining Performance Materiality

As explained in paragraph 2.2.2. of this report, PM plays a key role in the assessment of the RoMM and in the determination of the nature, timing and extent of the audit procedures. Its determination is not a simple mechanical calculation and involves the exercise of professional judgment.

Factors influencing PM [ISA 320.A13]	Auditor's understanding of the entity, updated during the performance of the risk assessment procedures
	Nature and extent of misstatements identified in previous audits and thereby the auditor's expectations in relation to misstatements in the current period

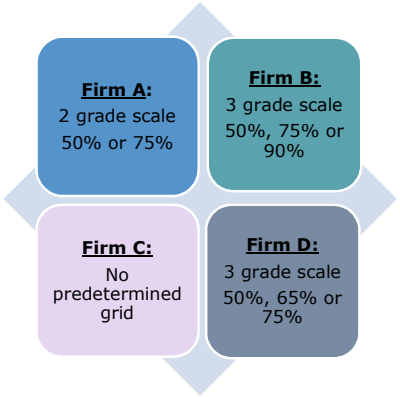
The above considerations are embodied and further developed in the Big 4 firms' audit methodologies, especially with regard to the key elements of the entity's understanding to be considered.

For illustrative purposes, the following factors are regularly quoted by the firms for determining the "haircut" percentage[14] to be applied to the OM.

- the history of misstatements;
- the effectiveness of the control environment;
- the changes in the business environment;
- the engagement risk;
- the attitude of management towards misstatements;
- the aggregation risk for misstatements;
- the turnover of senior management or key accounting personnel.

To complement the above, each firm except one, also set its own grid of expected percentages to be applied to OM in determining PM. The positioning of the auditor in the grid will vary depending on his or her evaluation of the relevant qualitative factors.

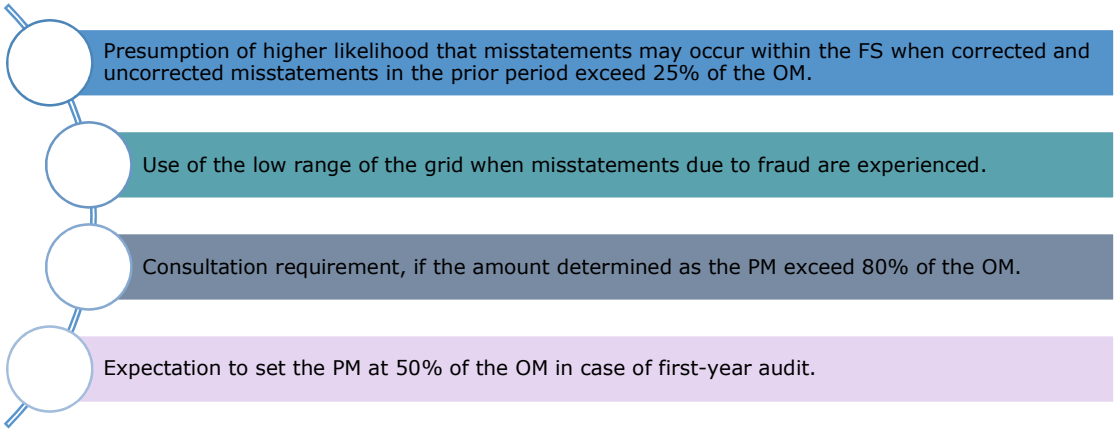
Expected percentages to be applied to the OM when determining the PM:



Based on this matrix, a consensus seems to emerge in the Big 4 firms' audit methodologies for applying, as a maximum haircut, a rate of 50% for engagements having the "worst" qualitative factors as listed above (i.e. higher risks, deficiencies in internal controls, history of misstaments, etc...). This is not necessarily the case on other engagements.

[14] When an auditor assesses the PM as 75% of the OM, this means a percentage reduction of 25% is applied to the OM (referred to as the "haircut")

To conclude this paragraph, the following guidelines have been observed at some firms, and are worth mentioning:



3.3. Determining Clearly Trivial Threshold

ISAs do not provide any qualitative guidance on the factors that may be considered by the auditor for setting CTT.

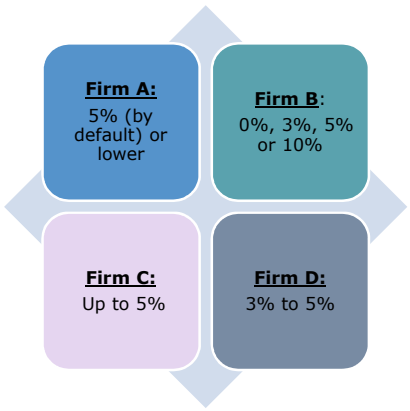
Big 4 firms' methodologies give some guidance to assist the auditors in their assessment even if it remains quite limited. These guidelines remind auditors that CTT should be determined using professional judgment and that factors similar to the ones used when determining PM could be considered.

This includes:

- the history of misstatements, whether corrected or uncorrected; and
- the expectations of the entity or those charged with governance.

All the firms however have issued quantitative guidance specifying "clearly trivial" limits that can be used by practitioners.

Clearly trivial threshold[15] (expressed as % of the OM)



Based on section 4.5, a consensus around 5% of OM seems to be broadly shared among the Big 4 firms to determine the amount of CTT. This percentage corresponds to the upper limit of all the firms except one.

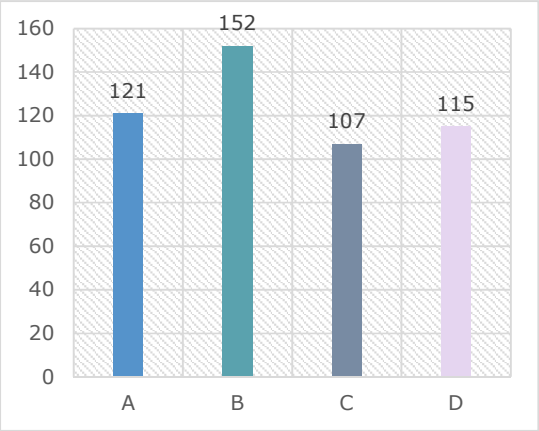
[15] The methodology of the Firm D has been updated to "Up to 5%" since the survey.

4. Determining materiality (in practice)

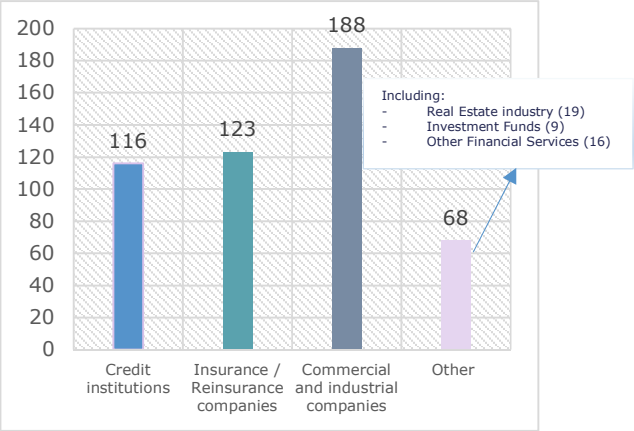
After having observed how Big 4 firms' methodologies support auditors in exercising their judgment to assess materiality, this section of the report depicts and analyzes, based on a sample of PIE audits, how audit professionals are applying their network guidance in practice.

To this end, **495** PIE audit files from **21**[16] different EEA countries have been analyzed. Audit files selected cover accounting periods ranging from 31 December 2018 Year-End to 31 December 2020 Year-End. The selected sample was distributed as follow:

Number of PIEs audit files per Big 4 firm:



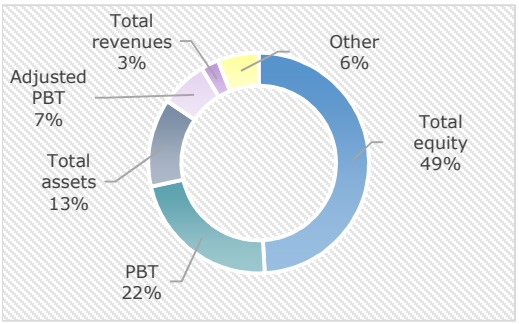
Number of PIEs audit files per industry sector:



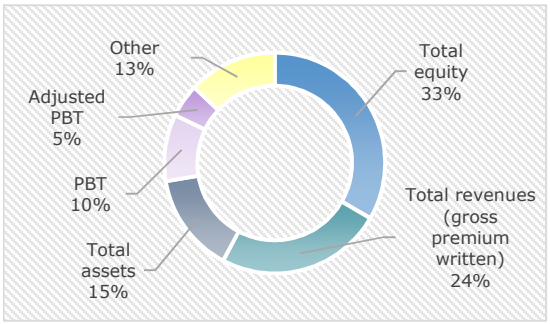
4.1. Most common benchmarks used by industry sector

Graphs below summarize, by industry sector, the most common benchmarks selected by auditors when determining the overall materiality.

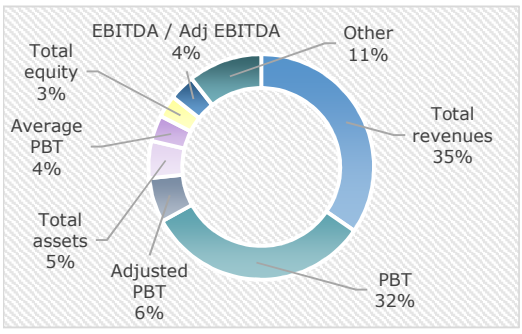
Credit Institutions:



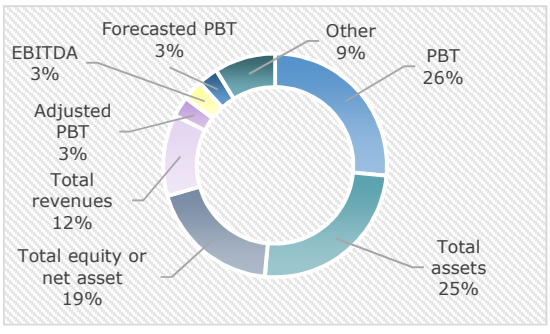
Insurance and reinsurance:



Commercial and industrial companies:



Other industries:



[16] The list of participating countries is provided in the Appendix 1 to this report.

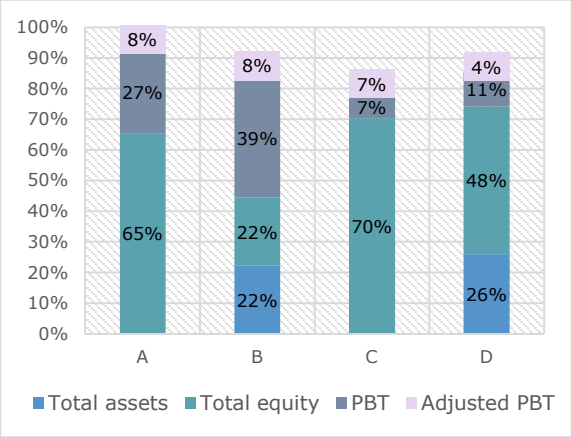
As illustrated, selected benchmarks vary depending on the industry sector in which the audited entity operates: "total equity" appears to be the most used benchmark for credit institutions and insurance/reinsurance companies, while "PBT metrics" tend to be used by professionals when auditing commercial and industrial companies, slightly ahead of "total revenues". It is also worth noting that no composite benchmark, built with the recourse of different aggregates, has been used by auditors in our sample.

The presumption embodied in each Big 4 firm methodology to consider an earnings-based benchmark (like PBT or PBTCO) as the most relevant metric for an equity issuer is also often rebutted by auditors. Among the arguments put forward by audit professionals to justify this decision, we can mention:

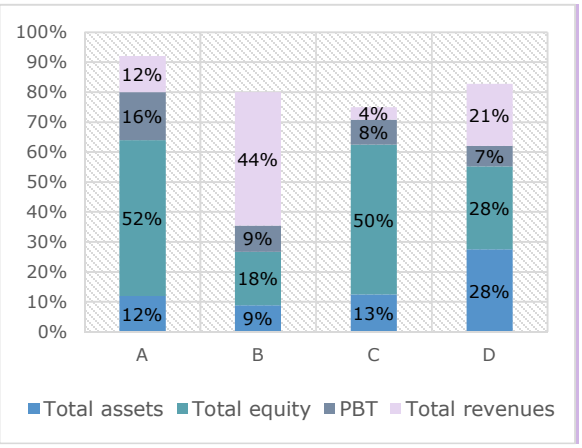
- the relative volatility of PBT or earnings-based benchmarks;
- losses incurred during the year or entity with low margins;
- the long-term nature of the business, which is not driven by short-term profit but rather by long term sustainability and market share.

While the benchmark used for the audit of industrial and commercial companies is relatively identical between the Big 4 firms, it is quite heterogeneous for the credit institutions and insurance companies, as illustrated in the two below graphs:

Credit Institutions:



Insurance and Reinsurance:



For the engagements in our sample operating in these two sectors, auditors of firms A and C use more frequently "total equity" as the most relevant benchmark. This trend is even more predominant for the banking sector, where approximately two out of three auditors use this benchmark for determining OM.

By contrast, auditors of firms B and D have a more varied practice. Auditors of these two firms are also the only ones having chosen "total assets" as the relevant benchmark for several engagements of the banking sector.

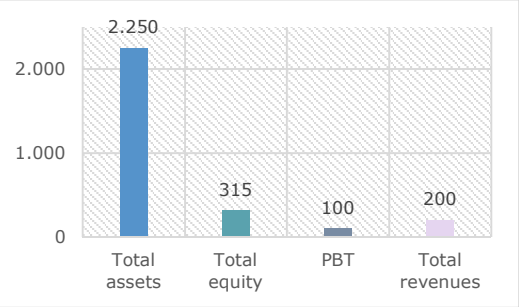
The selection of a benchmark is likely to have a significant impact on OM and so to affect the level of audit procedures carried out by the auditors. This is illustrated in the below example:

Illustrative example: Let's consider an insurance company, for which the auditor would use one of the widely observed benchmark for this industry as per the above analysis (i.e. Total equity, PBT, Total assets or Total revenues).

OM would be as follows, depending on the judgment made by the auditor when selecting the relevant benchmark.

Benchmark	Amount (M€)	%[17] applied
Total assets	300.000	0,75%
Total equity	18.000	1,75%
PBT	2.000	5,00%
Total revenues	20.000	1,00%

OM in M€:

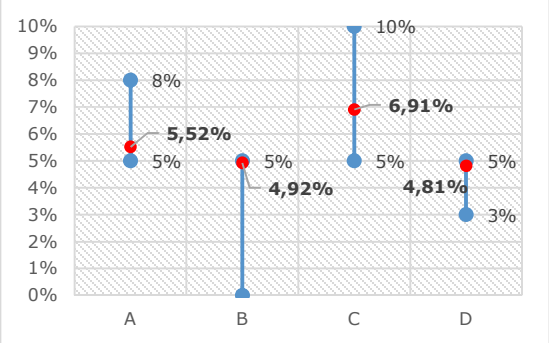


Using "Total Assets" as the relevant benchmark for this insurance company, the assessed OM (and as a matter of consequence, the resulting PM) would be significantly higher than those assessed based on the other benchmarks. In such a situation, most of the captions of the profit and loss accounts would not be subject to audit procedures. A similar conclusion would have been reached, had a credit institution been selected as the example.

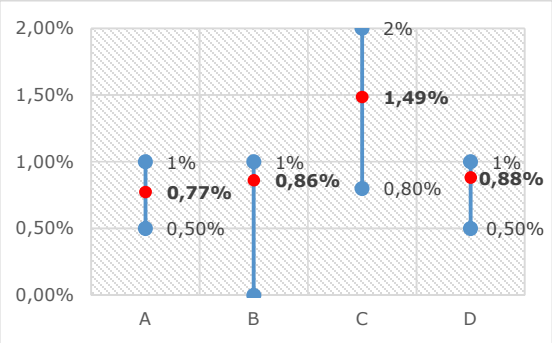
4.2. Percentages applied when determining overall materiality

Graphs below illustrate for a selection of relevant benchmarks, the average percentage (in red) applied by auditors for the surveyed sample, compared to the ranges of percentages as defined in their respective audit methodologies, as illustrated in section 3.1.4 above.

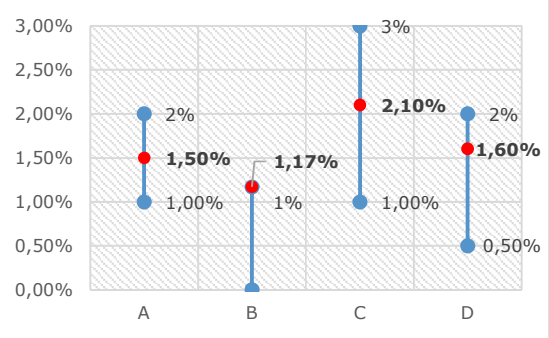
Profit before Tax:



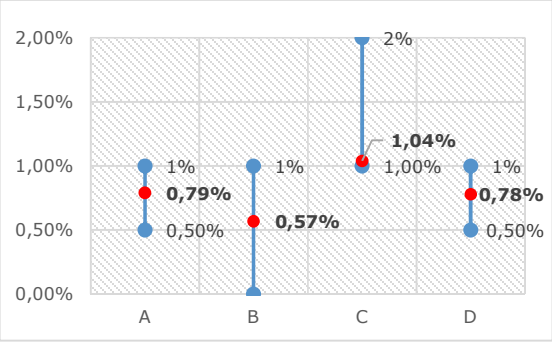
Total revenues:



Total equity:



Total assets:



[17] % used are also derived from observed % as per our sampling exercise – (refer to section 4.2)

If overall, one may point out a certain level of consistency between the firms in the observed average percentages applied by auditors on the above benchmarks, a closer look at this analysis points out several interesting lessons.

Indeed, we note that auditors of firm C are applying on average the highest percentages to each of the above four selected most common benchmarks. As outlined in section 3.1.4 above, the fact that firm C's methodology does not make a clear distinction in the presumed reasonable ranges of percentages to be applied to a chosen benchmark between listed entities and PIEs (incl. entities in regulated industries) on the one hand and the other entities on the other hand is certainly not innocuous in this observation.

Looking at "profit before tax", the most "popular" benchmark for PIEs audits, we observe that the average percentages for firms A and C are higher than those observed for firms B and D. This is not surprising since methodologies of firms B and D fix 5% as the presumed upper limit, while this threshold corresponds to the presumed bottom limit for firms A and C. The absence of a presumed range or grid in the ISAs literature may be a reason for this.

Ranges given in the firms' methodologies are rebuttable and, in certain situations, assessed OM may fall outside them. This occurred at the level of our sample for Firm B with the benchmark "Total equity". This outcome was mainly observed for the insurance industry and explained by the use of specific industry guidance issued locally in one jurisdiction. The fact that the upper limit of Firm B methodology for this benchmark corresponds to the lower limit of two other firms and to the lower range of the third one, plays certainly a role in this observation.

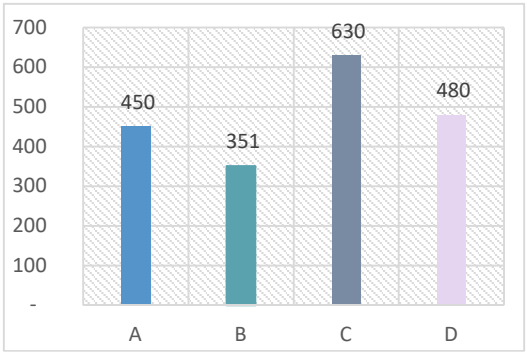
Lastly, if variances between the observed averages illustrated above may seem minimal, they nevertheless have a more than insignificant influence on the assessed materiality amounts, as illustrated in the below example.

Illustrative example: Let's take the example of a credit institution and consider that auditors would use the observed average percentage for the total equity benchmark when assessing OM.

The assessed amounts would be as follows:

Firm	Total equity (M€)	% applied
A	30.000	1,50%
B	30.000	1,17%
C	30.000	2,10%
D	30.000	1,60%

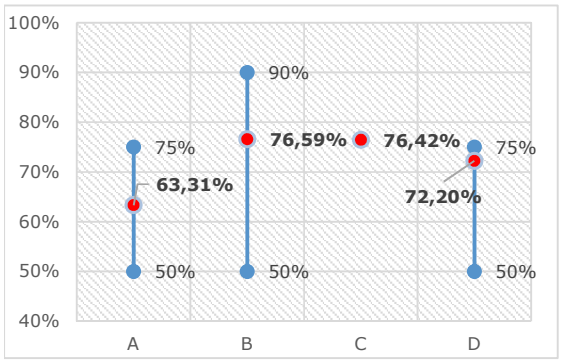
Comparison of the OM (expressed in M€):



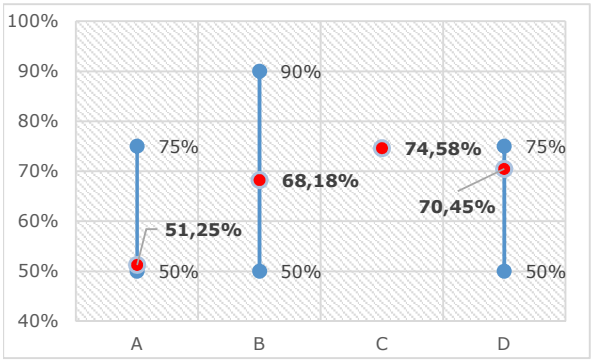
4.3. Percentages used to set Performance Materiality

The graphs below illustrate the average percentages used by auditors to set performance materiality on the audit engagements included in our sample.

Average % of PM – recurrent engagements:



Average % of PM – 1st year audit:



Not surprisingly, Firms A and D, which foresee a 75% upper limit according to their methodologies, are the two firms where the observed average PM percentages are the lowest with 63.3% and 72.2% respectively. However, the gap between these two firms remains significant as the average percentage used for Firm D is close to the upper limit, which is not the case for Firm A.

Based on our sample of 374 PIE audits concerning Firms B, C and D, the observed average percentages for these firms are relatively homogeneous. This result appears surprising considering that each firm has a different percentage grid or no grid at all as for Firm C. A skeptical observer may wonder whether a 25% haircut could not be perceived as a kind of standard rule, leaving the auditor with sufficient opportunity among the various relevant engagement facts and circumstances[18] for justifying his/her own judgment.

Working for a new client usually makes the audit more challenging as the auditor has to familiarize with the client's specificities, including its control environment and processes. In such situation, lowering the PM percentage would make sense to mitigate the audit risk.

Looking at the above chart on the right-hand side, it is interesting to note that Firm A and to a lesser extent Firm B, tend to share this view. In contrast, working on a first-year engagement, is apparently irrelevant when setting the PM percentages for Firms C and D. This finding is not unexpected based on the differences observed at the time of our survey on the firms' guidance for this consideration.

4.4. Correlation between performance materiality and engagement risk

We have seen in sections 3.1.4 and 3.2 of our report that many factors influence the determination of materiality percentages, leaving auditors with multiple levers for supporting their judgments.

In this section, we will have a closer look at the relationship between PM and engagement risk.

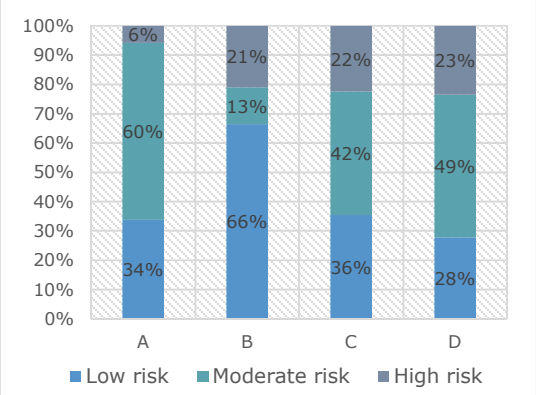
[18] Refer to the list of relevant characteristics given in section 3.2 (effectiveness of control environment, history of misstatements, attitude of management towards misstatements, changes in business environment…)

While doing this exercise, due acknowledgement must be taken of the fact that engagement risk does not correspond to the audit risk but rather to a broader notion, which is the overall risk associated with an audit engagement.

Bearing that in mind, the relationship between PM and engagement risk remains interesting to analyze since audit risk is an interrelated component of this broader notion, together with the auditor and client's respective business risks. Lastly, it is worth also mentioning that the definition of the materiality level is obviously not the sole nor the predominant lever for audit firms in addressing the engagement risks.

This survey focuses on materiality in the context of an audit, it will therefore not give a holistic view of how audit firms monitor engagement risks. However, this does not preclude CEAOB from analyzing whether determined PM percentages remain comprehensible and consistent with the overall engagement risks assessed by auditors.

Distribution of our sample's engagement risks for each Big 4 firm:



Without making any judgment about the risk assessment made by auditors, one may nevertheless question the proportion of high-risk engagements for Firm A and the one of low risk engagements for Firm B (both against the moderate risk population).

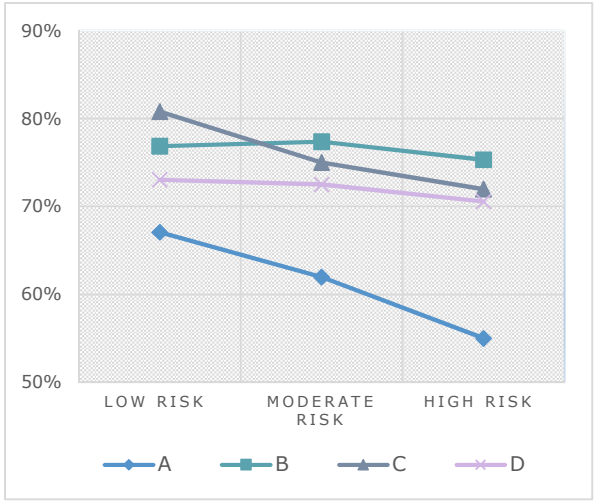
For these two audit networks, this may be an indication for the surveyed sample of 273 PIE audits, that their auditors have a different sensitivity to the engagement risk factors than the auditors of Firms C and D or that Firms A and B's reading grid of the engagement risk rating scale differs from the one of the other two firms.

The graph on the right illustrates the relationship between the PM % applied and the engagement risk level on the surveyed sample.

Firms A and C show relevant correlation results for these two variables, meaning that auditors use on average lower PM % when working on their riskier engagements (keeping in mind that Firm A has, based on our sample, fewer high-risk PIE audits than the other three networks). Firm C auditors apply however on average for all engagement risk categories lower haircuts than those of Firm A.

For Firms B and D auditors of the surveyed sample, engagement risk assessment has a clearly trivial influence on the determination of PM percentages. As mentioned in the foreword of this section, other decisions may have been taken to monitor the engagement risks (including when setting the OM).

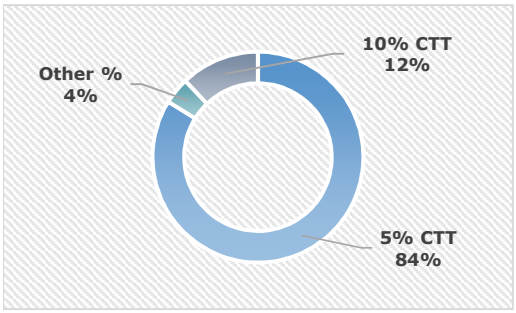
PM% versus engagement risk assessments:



4.5. Other observations

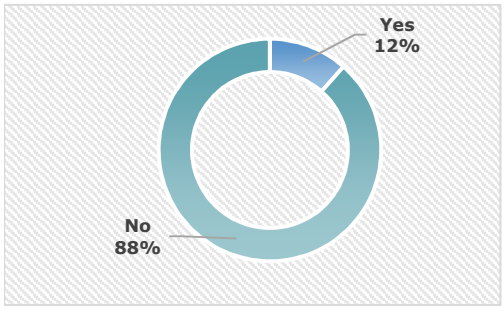
Graphs below illustrate other interesting observations raised in the context of our survey.

Clearly trivial threshold (in % of the OM):



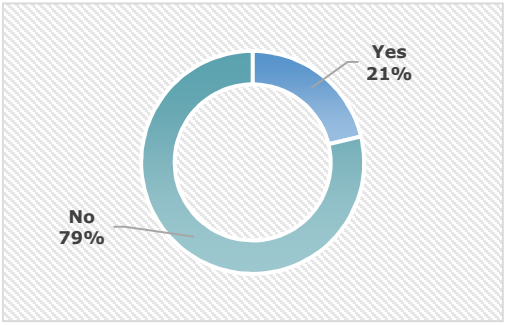
A consensus around the Big 4 firms seems to emerge to set the amount of CTT at 5% of the OM. We did not observe many instances where the CTT was duly justified in the audit engagements.

Lower materiality for account balances, classes of transactions (CoTs) and disclosures:



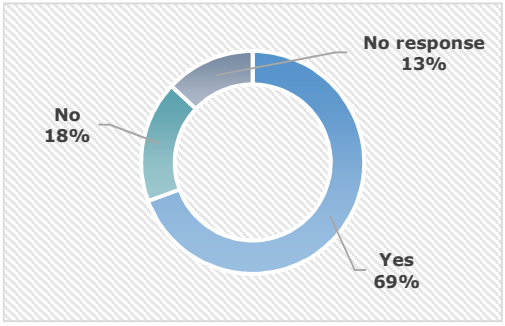
While audit firm's guidance provide that the auditor may consider setting lower materialtiy levels for particular account balances, CoT or disclosures, this was in practice the case in only 12% of our sample.

Consultation:



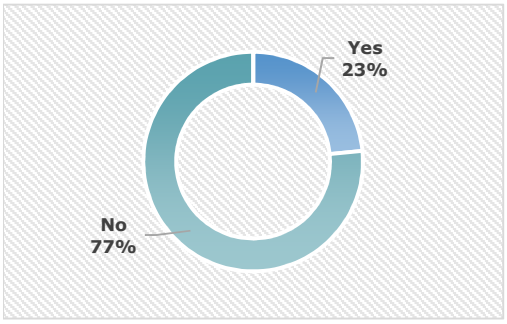
We observe that in 21% of cases, auditors of our sample consult internally either to confirm the appropriateness of the selected benchmark or the validity of the percentages applied when determining the OM or PM.

Consistent application of the benchmark:



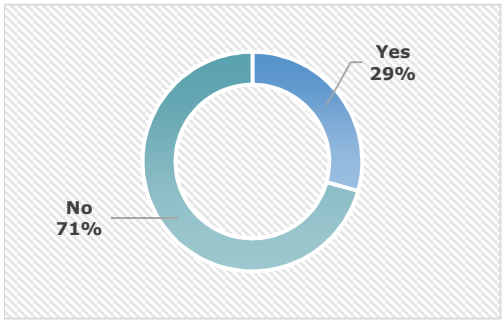
In 69% of cases, the benchmark selected by the auditors was applied consistently between the examined year and prior year. Changes were, mostly justified by the volatility of the benchmarks (taking into consideration material effect of COVID 19).

Disclosure of the materiality levels:



In 23% of cases, OM applied by the auditors was disclosed in the audit report. This percentage is explained either by the compliance of the auditors with existing local requirements (considering ISAs do not require such disclosure) or by the good practice observed in some jurisdictions for one audit firm.

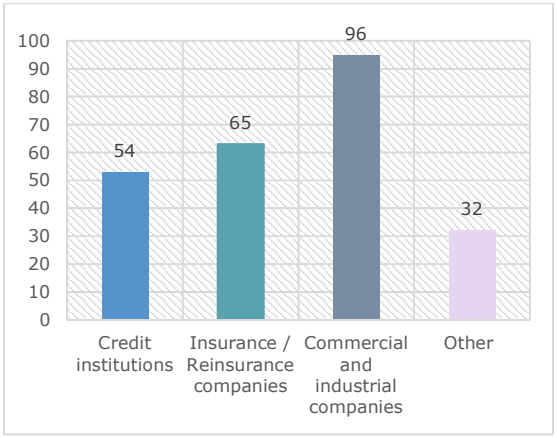
Revisit of the materiality levels during the audit:



In 71% of the cases, the auditors did not become aware of information during the audit that would have caused them to revisit the materiality levels initially determined.

5. Audit committees and materiality

ACCs are obviously not the only users of the FS and their views do not necessarily reflect those of other users of FS. Nevertheless, ACCs viewpoints on materiality remain interesting to collect in the context of our survey. This is why, we have invited a sample of ACCs to provide their views on various questions related to the materiality in audit. **247** completed questionnaires from **15**[19] different EEA countries have been analysed.

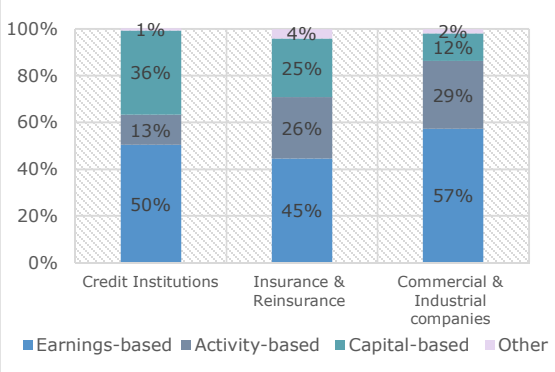


The responses received were from entities operating in the industry sectors illustrated on the right. The principal results raised in the context of this survey are illustrated below. No results are presented for the category "Other" as the number of answers received and the disparity of the industries included in that bucket do not allow for a relevant analysis.

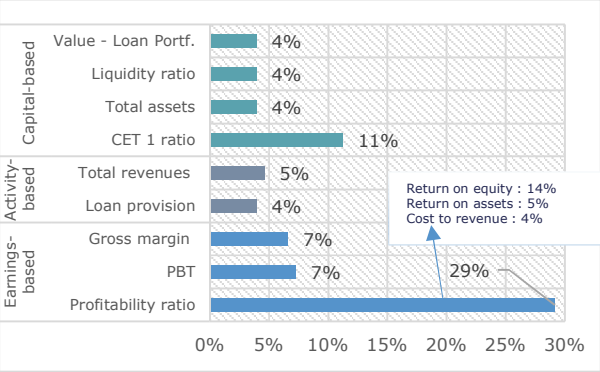
5.1. Main key performance indicators scrutinized by audit committees

The first question raised with ACCs was to list, from their point of view, the 3 main KPIs applicable to their entity. While considering KPIs, it should be noted that they do not necessarily correspond to "traditional" measures prescribed by accounting standards. This could obviously affect their reliability and usage legitimacy by auditors. Bearing that in mind, collected answers are illustrated below:

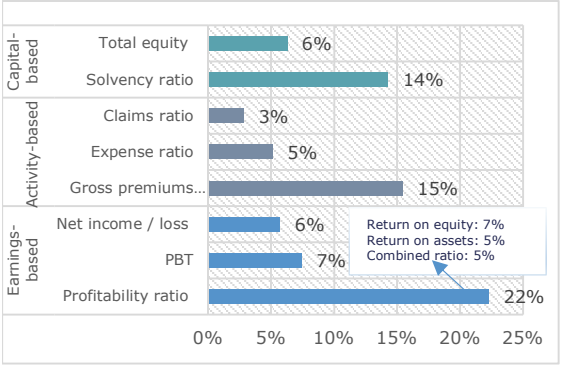
Distribution of the KPI's by industry sector:



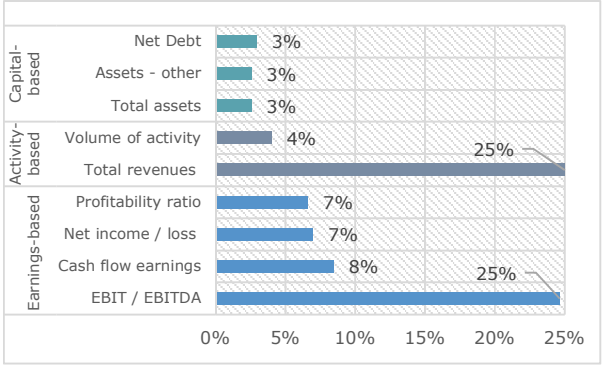
Most common KPI's: Credit Institutions



Most common KPI's: Insurance & Reinsurance



Most common KPI's: Commercial & Ind. companies



[19] The list of participating countries is provided in the Appendix 2 to this report.

There are many interesting observations which arise from above graphs.

First, earnings-based indicators prevail for all industries according to ACCs responses. Considering benchmarks elected by Big 4 auditors for the financial sector as disclosed in section 4.1 of our report, ACCs' view is not aligned with that of audit firms, with the notable exception of Firm B for their audits of credit institutions.

Second, looking more closely at the earnings-based category, we observe that PBT is not the main earnings-based indicator quoted by respondents. ACCs clearly favor EBIT or EBITDA measures for commercial and industrial entities and profitability ratios for the financial sector, like return on equity or return on assets.

Third, focusing on capital-based indicators for the financial sector, we observe that the item "Total assets" is rarely quoted by ACCs, while it is elected as the relevant benchmark for OM by more than one in four auditors of Firm D, as illustrated in section 4.1 above. More than one in five auditors of Firm B also used it for their audits of credit institutions.

Finally, looking at the activity-based indicator, we observe that the "Total revenues" is the main activity-based indicator quoted by ACCs.

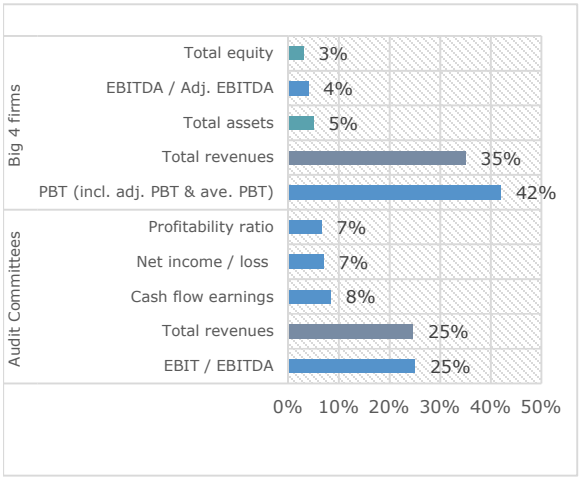
5.2. Comparison with the benchmarks selected by auditors

To complement the above analysis, we compared by industry sector, the top 5 KPIs scrutinized by ACCs with the five most frequently used benchmarks actually selected by auditors in our sample when determining the OM. While it may be interesting to analyze consistency or contradictions between those two variables, the reader shall keep in mind that OM for auditors does not have the same meaning and objective as KPI for management and ACCs.

The results of this analysis are presented below.

- earnings-based measures are presented in **BLUE**
- activity-based measures are presented in **GREY**
- capital-based measures are presented in **GREEN**

Commercial and Industrial companies



The choice of an earnings-based measure and to a lesser extent of an activity-based measure remains largely acclaimed by both ACCs and auditors of our sample for the entities operating in the "Commercial and Industrial" sector.

While PBT is clearly the number one benchmark of auditors, it does not represent the predominant KPI for ACCs, who tend to favour EBIT or EBITDA.

The choice of the "Total revenues" as a relevant indicator remains also largely favoured by both respondents for these entities.

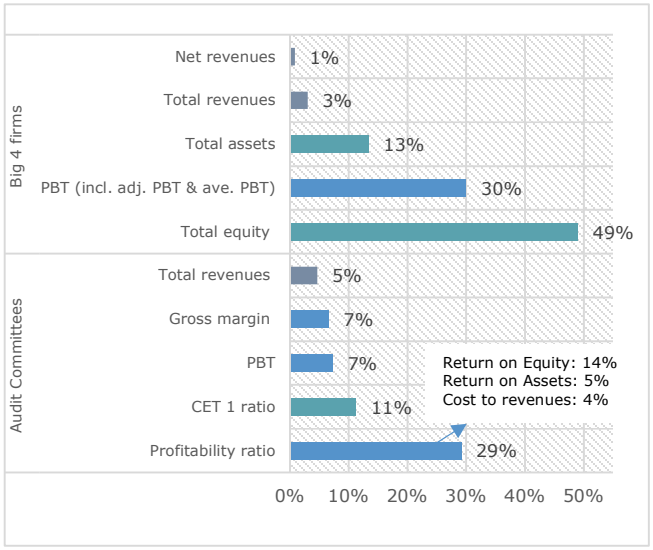
The picture looks however more heterogeneous for entities operating in the financial sector, where discrepancies were already observed between auditors themselves, as described in section 4.1 of this report.

Credit Institutions:

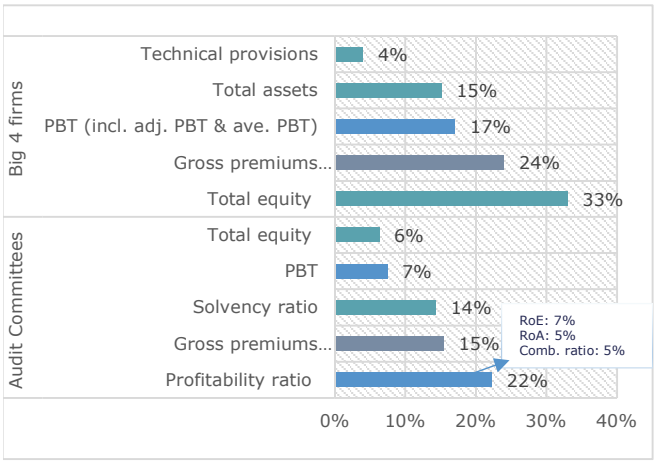
Focusing on the banking sector we can observe that ACCs of our sample tend to prefer the selection of earning-based measures whereas the auditors acting in this industry have a clear preference for the selection of capital-based measures with the notable exception of Firm B auditors as shown in section 4.1 of our report.

Even if ACCs do not consider the "Total equity" as such, as a relevant indicator, it can be observed that in 11% of the cases, they opt for prudential ratios, derived from equity, such as the Common Equity Tier 1 ratio[19] ("CET 1").

Finally, this graph helps to underline the different views between ACCs and auditors regarding the choice of "Total assets" as relevant indicator.



Insurance and Reinsurance:



As for credit institutions, auditors in the insurance and reinsurance sector prefer a capital-based measure when selecting the relevant benchmark for their audit. This trend is not reflected in the KPIs scrutinized by ACCs, which are more balanced between the three categories.

One auditor out of three in this sector choose "Total equity" as the relevant benchmark when assessing OM. However, this item does not dominate the Top 5 KPIs quoted by ACCs.

Overall and especially for entities operating in the financial sector, ACCs seem to be more inclined than auditors to select an earnings or activity-based benchmark instead of a capital-based measure.

As already illustrated in the section 4.1 of this report, the selection of the benchmark is a far from trivial decision when assessing the OM.

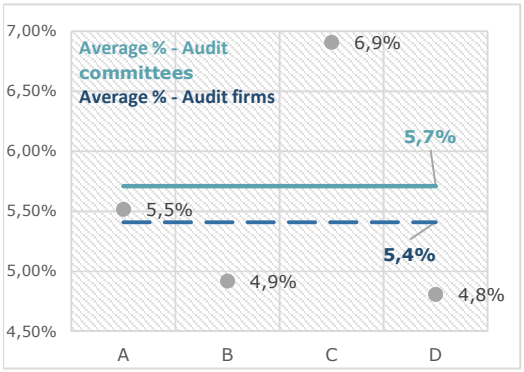
[19] the Common Equity Tier 1 Ratio is calculated by taking a bank's core capital relative to its risk-weighted assets

5.3. Comparison between the percentages applied by auditors and the expectations of ACCs

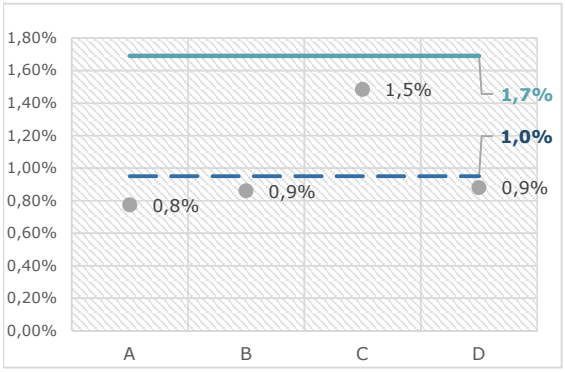
Graphs below illustrate for a selection of relevant benchmarks, the gap between the average percentage of misstatements above which ACCs consider the financial information to be materially misstated on the one hand, and the average rate effectively applied by the auditors when determining overall materiality on the other hand.

For information purpose, the average percentages observed for each Big 4 firm as per our sample of PIE audit files are also provided in the graphs.

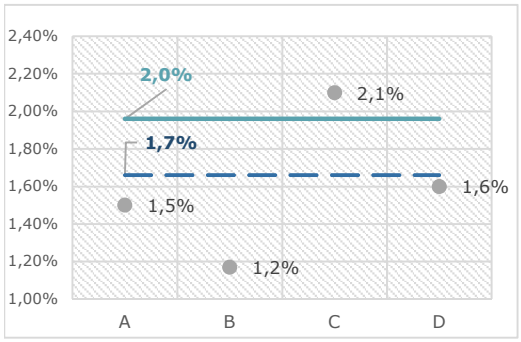
Profit before Tax:



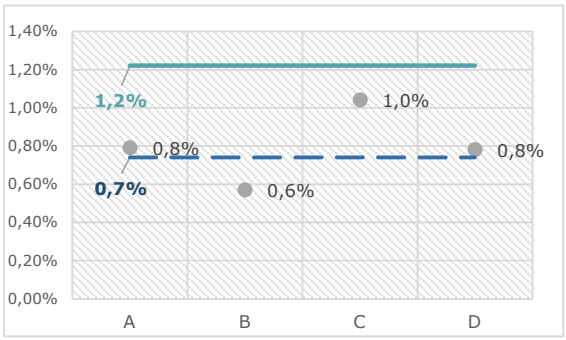
Total revenues:



Total equity:



Total assets:



Two main observations may be drawn from the analysis of the above charts.

First, for all the benchmarks considered in our analysis, we notice that the average rates used by the auditors when determining the OM are lower than the average percentages of misstatements above which surveyed ACCs consider the FS to be materially misstated.

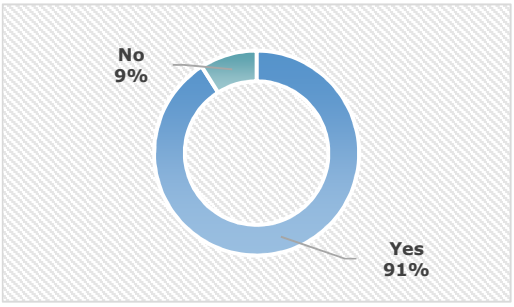
This observation can give rise to different interpretations: some may argue that the auditors are reasonably conservative when determining the appropriate percentage to be applied to a relevant benchmark, while others may question ACCs' positioning as far as the assessed percentages are concerned.

The second lesson learned from the above charts reiterates and emphasizes an observation made in section 4.2 above, namely that Firm C auditors use on average the highest percentages when assessing the OM relevant to their PIE audits. For two benchmarks, PBT and Total equity, the observed percentages are even higher than the ACCs average rates.

5.4. Interaction between the audit committees and the auditors on materiality

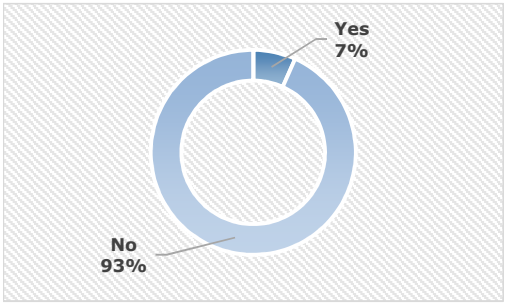
The questionnaire addressed to ACCs included a series of questions dedicated to appreciate the level of discussion ACCs have with their auditors on the materiality topic. The main conclusions raised from the answers received are provided in the graphs below:

Choice of the benchmark:



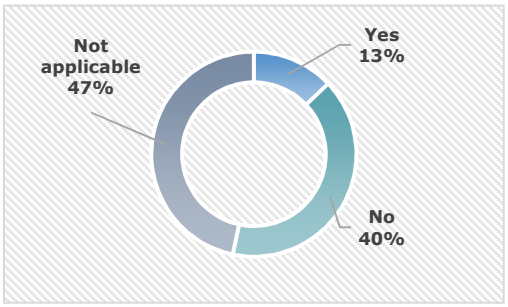
91% of ACCs confirmed the auditor appropriately explained his/her professional judgment about his/her choice of the benchmark used as a starting point for determining materiality for the financial statements as a whole.

Modification of the materiality after discussion with the auditors:



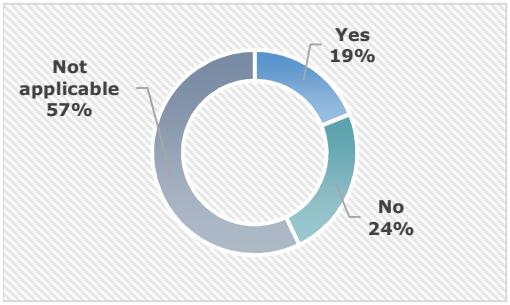
7% of ACCs indicated that their discussions on materiality over the last three years with the auditors led to a modification of the materiality levels initialy determined. 5% of them confirmed that the materiality level decreased after discussion.

Lower materiality levels:



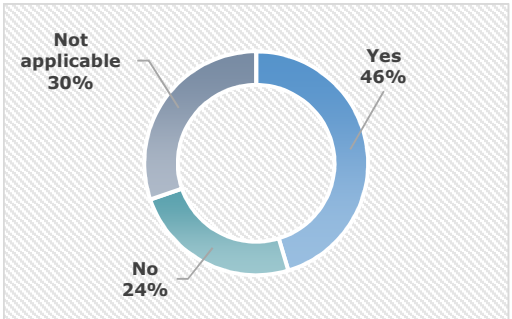
Only 13% of ACCs discussed with their auditors the need for determining a specific materiality for particular CoTs, account balances and disclosures.

Revision of audit materiality:



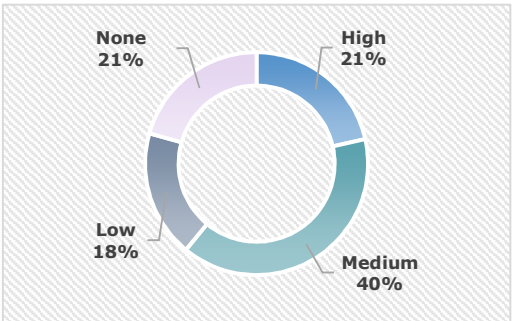
Although not required by ISAs, 19% of auditors discuss the need for revisions of the materiality with the audit committee.

Group audit:



24% of ACCs reported that the group auditor did not communicate the level of component materiality for the audit or review of the financial information of the significant components.

Level of importance of the materiality in the tender process:



More than 39% of ACCs did or will place low or no importance on materiality during their last, alternatively next, audit proposal. This percentage is unexpectedly high considering the importance of this notion in the audit process.

APPENDICES

Appendix 1 - List of national competent authorities having participated to Q2

Country	National competent authority
Austria	Audit Oversight Body of Austria - APAB Abschlussprüferaufsichtsbehörde
Belgium	Belgian Audit Oversight Board
Bulgaria	Commission for Public Oversight of Statutory Auditors
Croatia	Ministry of Finance
Cyprus	Cyprus Public Audit Oversight Board
Czech Republic	Public Audit Oversight Board
Denmark	Danish Business Authority
Finland	Patent and Registration Office, Auditor Oversight
France	Haut Conseil du Commissariat aux Comptes (H3C)
Germany	Auditor Oversight Body (AOB) – Abschlussprueferaufsichtsstelle
Hungary	Ministry of Finance (Auditors' Public Oversight Authority)
Ireland	The Irish Auditing & Accounting Supervisory Authority
Italy	Consob - Commissione nazionale per le società e la Borsa
Lithuania	Authority of Audit, Accounting, Property Valuation and Insolvency Management under the Ministry of Finance of the Republic of Lithuania
Luxembourg	Commission de Surveillance du Secteur Financier
Malta	Accountancy Board - Quality Assurance Unit
Netherlands	Dutch Authority for the Financial Markets (AFM)
Norway	Finanstilynet
Romania	Authority for Public Oversight of the Statutory Audit Activity
Slovenia	Agency for Public Oversight of Auditing
Spain	ICAC - Instituto de Contabilidad y Auditoría de Cuentas

Appendix 2 - List of national competent authorities having participated to Q3

Country	National competent authority
Belgium	Belgian Audit Oversight Board
Bulgaria	Commission for Public Oversight of Statutory Auditors
Croatia	Ministry of Finance
Cyprus	Cyprus Public Audit Oversight Board
Czech Republic	Public Audit Oversight Board
Denmark	Danish Business Authority
Finland	Patent and Registration Office, Auditor Oversight
Ireland	The Irish Auditing & Accounting Supervisory Authority
Lithuania	Authority of Audit, Accounting, Property Valuation and Insolvency Management under the Ministry of Finance of the Republic of Lithuania
Luxembourg	Commission de Surveillance du Secteur Financier
Malta	Accountancy Board - Quality Assurance Unit
Norway	Finanstilynet
Romania	Authority for Public Oversight of the Statutory Audit Activity
Slovenia	Agency for Public Oversight of Auditing
Spain	ICAC - Instituto de Contabilidad y Auditoría de Cuentas

GLOSSARY OF TERMS

ACC	Audit Committee Chair
BC	Business Combination
CEAOB	Committee of European Auditing Oversight Bodies
CET 1	Common Equity Tier 1
CoT	Class of Transaction
CTT	Clearly Trivial Threshold
EBIT	Earnings Before Interest and Tax
EBITDA	Earnings Before Interest, Tax, Depreciation and Amortization
ED	Exposure Draft
EEA	European Economic Area
EPS	Earnings Per Share
FS	Financial Statements
FSLI	Financial Statements Line Item
IAS	International Accounting Standards
IFRS	International Financial Reporting Standards
ISA	International Standards on Auditing
KPI	Key Performance Indicator
OM	Materiality for the Financial Statements as a Whole
PBT	Profit Before Tax
PBTCO	Profit Before Tax from Continuing Operations
PIE	Public Interest Entity
PM	Performance Materiality
R&D	Research & Development
RoMM	Risk of Material Misstatements
TCWG	Those Charged with Governance