Example: Materiality assessment position paper

Foreword

The following example of a materiality position paper sets out the materiality thresholds for an entity. It has been prepared in a manner that creates a base document for use by entities for preparing a materiality position paper for their own entity.

An overall materiality threshold may be a useful reference point to guide decisions about the application of materiality to particular items or groupings of items, and in determining the approach to be followed in respect to the correction of errors and misstatements.

In determining an overall materiality threshold, potential methods include a percentage income; percentage of gross profit; percentage of total assets; percentage of total revenue to equity; a mixture of the aforementioned methods or a scaled method that takes into account the size of the entity.

Common materiality guidelines include:

1. 5.0% of income (using a 3-year average)

2. 0.5% to 2.0% of revenue/expenses for non-profit organisations

3. 0.5% to 1.0% of net assets

The above materiality range for revenues/expenses of between 0.5% and 2.0% aligns with the guidance contained in RMG 125 where it is stated:

Reporting entities need to consider the materiality of variances. As a general guide, a variance may be considered material or major if it is:

- *more than +/- 10% of the line item for both Departmental and Administered; or*
- *more than +/- 2% of total expenses or total own-source revenue for Departmental only, and*
- *more than +/- 2% of the relevant sub-total for total expenses, revenue, assets or liabilities for Administered only.*

This practical example uses 2.0% revenue/expenses based upon Portfolio Budget Statements figures.

Materiality assessment for [Entity name] 20XX-XX financial statements disclosures

Purpose

The purpose of this position paper is to document the materiality policy and thresholds to be used in the preparation of the [entity name] 20XX-XX annual financial statements. The materiality thresholds will be used to support management decisions in relation to information disclosure in the 20XX-XX financial statements and identification of major variances for budgetary reporting purposes only. Any audit differences will continue to be worked through with the Australian National Audit Office (ANAO) on a case-by-case basis.

This document should be reviewed annually and updated where necessary to account for any changes in funding, thresholds, legislation and guiding rules for the entity's assessment of materiality in its financial statements.

[Entity's name] position

1. [Entity's name] considers the appropriate materiality threshold for the 20XX-XX Financial Statements *information disclosure* to be 2% of Portfolio Budget Statements revenue balances for Departmental and Administered items. This results in a materiality threshold of $X million for Departmental items and $X million for Administered items. Refer to Attachment A for Finance's 20XX-XX materiality assessment.

2. In addition to applying materiality thresholds, [entity's name] will also apply professional judgement and consider relevancy for users of its financial statements when assessing items for disclosure. This may result in information disclosed that may not be numerically material but by nature may assist users to understand the underlying business transactions, conversely application of professional judgement may result in disclosures for material items not being equal in terms of size and detail.

3. For the 20XX-XX Financial Statements *budgetary reporting*, [entity's name] considers an actual to budget variance material or major if it is greater than the following materiality thresholds:

    a. for Departmental items only: more than +/- 2% of Departmental revenue in line with the defined materiality threshold for [entity's name] for YEAR (refer Attachment A); **and**

    b. for Administered items only: more than +/- 2% of the relevant sub-total for total expenses, revenue, assets or liabilities in line with the defined materiality threshold for [entity's name] for YEAR (refer Attachment A).

4. This materiality assessment applies to the 20XX-XX Financial Statements. [Entity's Name] will undertake an annual review of materiality and adjust where necessary.

5. [Entity's Name] will not apply materiality assessment against disclosures which are material by nature such as appropriations and special accounts, and mandatory by the *Australian Accounting Standards* (AAS), the *Public Governance, Performance and*

Accountability Act 2013 (PGPA Act) and the PGPA (*Financial Reporting) Rule 2015* (FRR) and other authoritative requirements.

Background

Section 42 of the PGPA Act requires [entity's name] to prepare Financial Statements in accordance with AAS and the FRR. AAS and FRR's require that entities should present all information necessary in its Financial Statements so as to present fairly its financial position, financial performance and cash flows. Furthermore, the AAS and FRR require that materiality must be assessed by entities in determining disclosure requirements.

For 20XX-XX Financial Statements, [entity's name] is aiming to improve usefulness and readability to users by simplifying disclosures and reducing unnecessary clutter. In revising disclosures, [entity's name] has also considered materiality of information and compliance with AAS and the FRR.

Defining materiality

Materiality can be difficult to define as it is based on both quantitative and qualitative factors, with the latter being more difficult. The AAS provide some guidance which is contained in *AASB101 Presentation of Financial Statements* & *AASB108 Accounting Policies, Changes in Accounting Estimates and Errors* and *AASB1060 General Purpose Financial Statements – Simplified Disclosures for For-Profit and Not-for-Profit Tier 2 Entities.*

As per AASB101.7 and AASB1060.22 *"Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity."*

AASB101.7 further states *"Materiality depends on the nature or magnitude of information, or both. An entity assesses whether information, either individually or in combination with other information, is material in the context of its financial statements taken as a whole."*

Finally, AASB108.8 highlights the need to balance AAS requirements with materiality assessments. Whilst it is appropriate to not apply some accounting policies where the effect is immaterial, *"it is inappropriate to make, or leave uncorrected, immaterial departures from the AAS to achieve a particular presentation of an Entity's financial position, financial performance or cash flows."*

Setting the materiality threshold for 20XX-XX

The ANAO sets an "audit materiality" threshold for each entity in accordance with the auditing standards made by the Australian Auditing and Assurance Board. These materiality levels are expected to be conservative and are not generally shared with audit clients. Whilst [entity's name] does not have access to the ANAO adopted materiality threshold, it is prudent to define materiality in [entity's name] financial statements.

The entity-defined materiality threshold for information disclosure which is calculated as 2% of 20XX-XX revenue balances for Departmental and Administered items is consistent with the AAS (refer Attachment A). This judgement is guided by consideration of the impact the

omission, misstatement or non-disclosure has individually or collectively on the discharge of accountability by the department.

Portfolio Budget Statements (PBS), rather than prior year actual expenses[1], have been used to determine the current financial year materiality levels, given the variation in funding that occurs between years. Therefore, in 20XX-XX, total expenses as per the budgeted financial statements in the 20XX-XX PBS will be used as the base.

[Entity's name]'s methodology for calculating the appropriate materiality threshold is also consistent with guidance provided in RMG125, an extract of which is included below in discussion around budgetary reporting.

This threshold is however not definitive and [entity's name] reserves the right to apply professional judgement having regard to both quantitative and qualitative aspects of information, including the capacity to affect risks and opportunities of [entity's name] operations. [Entity's name] will also consider the needs of the users such as senior management, Parliament, other accountable authorities and the public in applying this methodology.

Specific line item considerations

In applying the above levels, [entity's name] will remain mindful of any qualitative factors impacting on its materiality assessment - in particular whether the nature of the particular items causes it to be material even though it would be judged immaterial on the basis of the amount involved.

Part 6 of the FRR specifies that information on appropriations and special accounts must be disclosed, regardless of materiality. Therefore, in order to give a true and fair view, the disclosure of these items must not take into account any materiality threshold.

For other required disclosures, tolerance levels for misstatements at an individual line item needs to be assessed by [entity's name] on a case by case basis with regard to the inherent risk, effectiveness of internal controls, volume and quantum of errors expected and degree of subjectivity underpinning the measurement of the account balance.

While the materiality threshold is set at X% due to the impracticality in setting a single materiality level for individual line items, individual line items may also be considered in the context of other appropriate measurement bases. An appropriate measurement base could be all items in the financial statements, relative items, or classes of items. For example:

a. balance sheet items could be assessed relative to the appropriate asset or liability base
b. cash flow items could be assessed against the net cash flow for operating, investing or financing activities, and
c. statement of comprehensive income items could be assessed against relative net revenue and net expense figures.

[1] Each entity undertake and document an annual assessment of the relative accuracy of historical prior year actuals compared to PBS balances as a determinant of expected current year actuals and change the materiality basis if required.

Budgetary reporting

AASB 1055 Budgetary Reporting does not define a 'major variance' or provide any specific guidance on what would constitute a major variance. AASB1055.15 states that explanations of major variances are: *"…those relevant to an assessment of the discharge of accountability and to an analysis of performance…, not merely focusing on the numerical differences between original budget and actual amounts. They include high-level explanations of the causes of major variances rather than merely the nature of the variances."*

Further guidance is contained in RMG 125:

6. *Reporting entities need to consider the materiality of variances. As a general guide, a variance may be considered material or major if it is:*
    a. *more than +/- 10% of the line item for both Departmental and Administered; or*
    b. *more than +/- 2% of total expenses or total own-source revenue for Departmental only; and*
    c. *more than +/- 2% of the relevant sub-total for total expenses, revenue, assets or liabilities for Administered only.*

[Entity's name] has considered the requirements of AASB 1055 and guidance in RMG 125 and adopted the materiality thresholds for budgetary reporting purposes outlined below:

a. **for Departmental items only:** more than +/- 2% of Departmental revenue defined materiality threshold for [Entity's name] for 20XX-XX (refer Attachment A), and

b. **for Administered items only:** more than +/- 2% of the relevant sub-total for total expenses, revenue, assets or liabilities in line with the [Entity's name] defined materiality threshold for 20XX-XX (refer Attachment A).

Attachment A – Materiality assessment for 20XX-XX

[Entity's name] has performed calculations for materiality on the following balances derived from Portfolio Budget Statements (PBS).

These calculations are in line with guidance included in the FRR in Section 7 Paragraphs 1 and 2:

- Own Source Revenue—which excludes Gains and Revenue from Government.
- Expenses—based on expenses included in Net Cost of Services.
- Assets—includes all financial and non-financial assets balances.
- Liabilities—includes all payables and provisions.

[The following tables are examples only. If these are used as a basis for preparing an entity specific position paper, use the relevant PBS amounts for the entity]

Departmental		
Major Category	20XX-XX ***PBS $'000***	***2% Materiality Threshold $'000***
Own Source Revenue	500,000	10,000
Expenses	550,000	11,000
Assets	1,000,000	20,000
Liabilities	700,000	14,000
Administered		
Major Category	20XX-XX ***PBS $'000***	***2% Materiality Threshold $'000***
Own Source Revenue	500,000	10,000
Expenses	10,000,000	200,000
Assets	250,000	5,000
Liabilities	1,000,000	20,000

Recalculation using prior-year financial statements actuals

These materiality levels are reasonably consistent when compared with a calculation based on the prior financial statements for 20XX-XX using 2% of revenue which yielded similar results.

Departmental		
Major Category	20XX-XX ***Actuals $'000***	***2% Materiality Threshold $'000***
Own Source Revenue	467,253	9,345
Expenses	563,125	11,263
Assets	956,000	19,120
Liabilities	697,740	13,955
Administered		
Major Category	20XX-XX ***Actuals $'000***	***2% Materiality Threshold $'000***
Own Source Revenue	467,565	9,351
Expenses	9,652,360	193,047
Assets	268,632	5,373
Liabilities	1,120,658	22,413