The concept of materiality and the need to embrace it

By Milton Segal

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The concept of materiality is one of the most fundamental and significant concepts within the financial and corporate reporting ecosystem.

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It can be defined and rationalised in numerous ways, but the following encompasses the essence of the concept:

- Materiality is a concept or convention within auditing and accounting relating to the importance/significance of an amount, transaction, or discrepancy (Wikipedia).
- Materiality is a relative size or amount above which transactions or occurrences can be considered material or relevant, and below which can be considered immaterial or irrelevant.
- Materiality is a point above which attention needs to be paid to the specific issue or issues at hand, and below which less attention or possibly even no attention or input is required.

There are numerous other variations and forms of the above concept, but one clear common theme is that materiality represents a threshold, a gate-keeper and a clear reference to a quantum above which more discretion and judgement may be required. To this end, the higher the amount by which a transaction or balance exceeds materiality, the higher the level of attention required. The question is, by whom?

Materiality from whose perspective?

From a pure accounting sense, materiality is the ability to influence the decision making of the affected party. From the opposite perspective, a transaction or an amount is immaterial if it is unlikely to influence the decision making ability or ultimate decisions of the affected party.

It makes sense then that the various role players within the financial reporting ecosystem may have varied views of materiality depending on what the likely impact on their decisions will be should facts and or circumstances change.

Consider the external audit function. The objective of an external audit is to provide reasonable assurance that the annual financial statements (AFS) fairly present, in all material respects the results of the operations of the entity for the financial year. From an external auditor's perspective, the concept of materiality could potentially be twofold.

Material from the perspective of the stakeholders most likely to be impacted by reliance on the AFS – for example lenders, creditors, employees, etc.
Material from the perspective of how important/significant the risks of being associated with this particular entity may be to the audit firm concerned.
From an external audit perspective, themes around materiality seem to portray an acceptable or tolerable level of either risk, or accuracy or detail or a combination of these.

Consider, however, materiality from an internal audit perspective. Internal auditors play a very different role within the financial reporting ecosystem to that of external auditors. Internal auditors, as the name implies, are part of an entity's combined assurance model and are focused on systems and controls and the application of these controls. These auditors focus on the functioning of controls, compensating controls and often implement suggestions to further strengthen internal compliance.

To internal audit then, the concept of materiality differs. Whereas external auditors focus on amounts, quantities and their impact; a breakdown in controls or an error detected by internal audit may in fact be very material, i.e. significant, because their view of materiality is pointed towards the likelihood of further weaknesses, errors or mistakes rather than how much, for example, the error was. Errors and weaknesses to the internal auditor may and most likely will be material even if the error or weakness found caused an immaterial financial error.

As an example, an unaccounted for difference of R100 will in all likelihood be irrelevant and thus immaterial from a financial reporting and external audit perspective, but the fact that a system of controls allowed it to happen could be significant (read material) from an internal audit perspective. As demonstrated from this, the external versus the internal auditor's view of materiality is very different.

Multi stakeholder approach

Using the analogy above, not only does materiality differ between who may be affected by the transaction or event under question, but also who judges or evaluates the process of determining materiality. Therefore, materiality has multitudinous qualities as it may, or may not very significant or totally irrelevant (immaterial) depending on whose perspective is being evaluated. In short, a multi-capital and -stakeholder approach is required. This by no means makes considerations of materiality easier, in fact, it is quite the opposite.

Materiality, it seems, requires careful and due consideration to factor in a diverse range of possible or probable outcomes, and this requires one of the hardest skills and qualitative characteristics to both train and implement that of judgement. To understand materiality and to be able to decide whether an event or transaction is material, requires a high degree of judgement. And this raises the magnitude of the task tenfold.

Judgement in this context refers to the ability to apply one's mind and rationalise a host of possible outcomes in order to make an informed opinion of the best or most practical or meaningful outcome and decision.

In some cases, materiality could and perhaps should be irrelevant. These could be cases where the errors or transaction were deliberate and done with the intention to hide or deceive, and in these cases the fact that they exist cannot be ignored, irrespective of amount. They are material by nature and must be acted upon and considered.

If we are to improve the status of our economy, the quality of our reporting and emerge from these trying Covid-19 times, we should all apply the concept of materiality and its inherent judgement from a multi-stakeholder approach in the decisions we take and the actions we carry out. Dare we say, we need to use an integrated thinking approach.

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