Small and Medium Practices Committee

IFAC

Guide to Review Engagements

International
Federation
of Accountants

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International Federation of Accountants
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The SMP Committee of the International Federation of Accountants (IFAC) represents the interests of professional accountants operating in small- and medium-sized practices (SMPs). The committee develops guidance and tools and works to ensure the needs of SMPs are considered by standard setters, regulators, and policy makers. The committee also speaks out on behalf of SMPs to raise awareness of their role and value, especially in supporting small- and medium-sized entities, and the importance of the small business sector overall. Learn more at www.ifac.org/SMP.

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Note

The responsibility to communicate matters with both management and TCWG does not change when different persons are responsible for management and governance. Its only effect would be on the form or timing of the communication.

In some situations, local laws or regulation may:

- Restrict communication of certain matters with TCWG, such as a communication that might prejudice an investigation by an appropriate authority into an actual or suspected illegal act. If there is doubt about a particular communication, it is suggested that legal advice be obtained.
- Require a regulatory or an enforcement body to be notified of certain matters (such as misstatements identified or not corrected) or to provide a third party with a copy of the practitioner's written communications with TCWG (such as a management letter). In these situations, consider the need to obtain the prior consent of management or TCWG before doing so.

4.2 DETERMINE AND APPLY MATERIALITY

Paragraph	Requirement
	Materiality in a Review of Financial Statements
43	**The practitioner shall determine materiality for the financial statements as a whole, and apply this materiality in designing the procedures and in evaluating the results obtained from those procedures. (Ref: Para. A70–A73)**

In many situations, the AFRF being used for the preparation of the financial statements will include a discussion of materiality, which equally applies to both audit and review engagements. This will provide a frame of reference for determining materiality. If such a discussion is not included in the framework, the guidance contained in ISRE 2400 (Revised) can be used.

Practitioners are required to determine materiality for the financial statements as a whole. The concept of materiality recognizes that some matters (such as the magnitude of misstatements in financial statements, including omissions of information) could influence a group of persons making an economic decision, such as investing in, or lending money to, an entity, when taken on the basis of the financial statements. Consequently, misstatements, including omissions, are generally considered to be material if they (including individually immaterial items that could amount to a material misstatement when taken together) could reasonably be expected to influence the economic decisions of users when taken on the basis of the financial statements.

Since materiality is determined on the basis of both the financial statements and the practitioner's assumptions as to users of those financial statements, in practice, the determination of materiality may be influenced as the practitioner develops an understanding of the entity and its environment and performs review procedures. For example, information gained in obtaining an understanding of the entity may cause the practitioner to reassess their original assumptions about users. Equally, findings from review procedures may cause the financial statements to be amended prior to management finalizing them. Thus, in practice, determination of materiality is unlikely to be a discrete phase of a review engagement.

In some situations, judgments about materiality will reflect the nature of a matter as opposed to the amount involved. For example, a minor fraud, an undisclosed related party transaction, or evidence of management bias could have minimal impact on statement users, but could be considered very serious from a governance standpoint, as it may cast doubt on the integrity of management and would have a significant impact on the review procedures performed. Also, what would appear to be an isolated incidence of minor fraud may need to be further investigated, as it could be indicative of more widespread fraudulent activity.

Note that because a review engagement consists primarily of inquiry and analysis, there is no need to determine "performance materiality," which is used in an audit engagement for determining the extent of testing required for particular classes of transactions, account balances, or disclosures.

4.2-1 Calculate Engagement Materiality

Misstatements in the financial statements may arise from a number of causes, such as:

- Fraud and error;
- Departures from the AFRF;
- Inappropriate estimates; and
- Less than adequate, or omitted, disclosures of important information.

When a misstatement or the aggregate of all misstatements is significant enough to change or influence the decision of an informed group of financial statement users deemed to have common financial information needs (e.g., creditors, bankers, investors, donors, tax authorities, and regulators), a material misstatement has occurred. Below this threshold, the misstatement is regarded as immaterial. However, the possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered unless the engagement is intended to meet the particular needs of specific users.

Materiality is not a fine line. It represents a grey area between what is very likely immaterial and what is very likely material. Consequently, the assessment of what is material is always a matter of professional judgment.

Materiality also involves both qualitative and quantitative considerations. In some cases, misstatements of relatively small amounts could have a material effect on the financial statements. Examples could include a misstatement that has the effect of turning a small profit into a loss, an illegal payment of an otherwise immaterial amount, or failure to comply with some regulatory requirement that could result in a material contingent liability.

Determining materiality for the financial statements as a whole involves the steps in the following exhibit.

Exhibit 4.2-1A

Action Step	Description
Identify the Intended Financial Statement Users	Who are the most likely common users of the financial statements? This could well be the owner-manager and the entity's bank. However, consider other stakeholder groups who may make reasonable economic decisions based on the financial statements. Examples include TCWG, investors not involved in day-to-day operations, members of a not-for-profit entity, financial institutions, franchisors, major funders, employees, customers, creditors, and government agencies and departments.
Determine the Likely Needs of Intended Users	Will the groups of identified users focus primarily on the operating results, such as sales revenue expenses or profits and losses, or will they be more interested in the entity's assets, liabilities, and equity? Also consider expectations such as compliance with sensitive laws and regulations, revenue/expense allocations, and industry-specific disclosures. In this context, it is reasonable to assume that users: • Have a reasonable knowledge of business, economic activities, and accounting and a willingness to study the financial statements with reasonable diligence; • Understand that financial statements are prepared, presented, and reviewed 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 financial statements.
Establish the Level of Misstatement that Would Be Material to Users	Based on the information obtained about users, use professional judgment to determine the highest amount of misstatement(s) that could be included in the financial statements without affecting the economic decisions made by the financial statement users. If materiality is set too low, it will likely result in additional procedures being necessary to address the lower threshold of potential misstatements.

Action Step	Description
Rules of Thumb	Rules of thumb provide a general guide for calculating materiality based on the needs of the financial statement users. However, they are not a substitute for first identifying the groups of users and their needs. • **For profit-oriented entities**, a percentage of income, before taxes, from continuing operations could be used after any adjustment to normalize the base, such as bonuses or nonrecurring items. Other possible rules of thumb would include a percentage of revenues, expenditures, assets, or equity. • **For not-for-profit entities**, a percentage of revenues, expenditures, or assets could be used.
Document the Materiality Amount and Reasoning	Include in the file documentation: • The amount established for materiality; • The factors considered in determining materiality; and • Details of any revision to materiality as the engagement progressed.

Consider Point

Materiality for the financial statements as a whole relates to the needs of the intended users of the financial statements. It does not relate to the level of assurance being provided or the likelihood that material misstatements exist in the financial statements. Consequently, the amount established for materiality is generally not likely to require revision during the engagement unless there has been a major change in the circumstances of the entity or the information used to determine materiality in the first place. Refer to Section 4.2-3 of this chapter.

When factual misstatements are identified, other than those that are clearly trivial, practitioners often request that management make an adjustment regardless of the size. If management refuses, the reasons need to be carefully considered, as this could raise questions about management's integrity.

Example

Damien Maquire owns a sporting goods store that has annual sales of €620,000 and a net profit before taxes of €79,000. The total assets are €430,000 and Damien has a bank loan of €200,000 secured by the inventory in the store.

The calculation and documentation of materiality could be as follows:

Financial Statement Framework

IFRS for SMEs, which includes the concept of materiality based on the extent of misstatements (including omissions), that could reasonably be expected to influence the economic decisions of users when taken on the basis of the financial statements.

Financial Statement Users

The major user will be the owner-manager and his family, plus the bank (whose financial information needs to include the amount of inventory being held as security, the profitability of the store, and the resulting cash flow available to service the loan).

Normalized Annual Income

Normalized annual profits total €129,000. This is the €79,000 profit before tax, plus the bonus of €50,000 that was paid to Damien based on the results.

Calculation of Materiality

The following bases for determining materiality were considered:
- 5 to 10 percent of normalized profits before tax. This would provide a materiality amount of between €6,450 to €12,900.
- 1 to 2 percent of revenues. This would provide a materiality amount of between €6,200 to €12,400.
- .5 to 1 percent of total assets. This would provide a materiality amount of between €2,150 to €4,300.

Given that the stated users would be primarily interested in the profitability of the entity, it is my professional judgment that a materiality amount of €10,000 would be appropriate for this engagement. This is based on just under 8 percent of normalized profits before tax.

4.2-2 Apply

Once established, the materiality amount will serve as a benchmark for planning the procedures to be performed and evaluating the information obtained. The principal uses for materiality are outlined in the following exhibit.

Exhibit 4.2-2A

Common Applications of Materiality	Communicate to the team members and TCWG what materiality threshold will be used. [2400.43]
	Determine what financial statement items, including disclosures, are material. [2400.47(a)]
	Identify areas in the financial statements where material misstatements are likely to arise [2400.45] so that work efforts may be focused on addressing those areas. [2400.47(b)]
	Provide a context for evaluating the information obtained as a result of performing the planned procedures.
	Assess whether the information obtained causes the practitioner to believe that the financial statements may be materially misstated and, if so, plan what additional procedures are required.
	Evaluate the nature and impact of identified misstatements and, if not corrected, whether a modification to the review engagement conclusion is required as a result.
	Assess any new information obtained that could require a revision to the initial determination of materiality.

Consider Point

Documentation of Misstatements

At the planning stage, it would be useful to address:
- How misstatements, when identified (as a result of performing review engagement procedures), will be documented and accumulated with other misstatements; and
- When management will be asked to make the appropriate corrections (such as when identified or in the latter stages of the engagement).

Trivial Misstatements

It may also be useful to determine an amount below which a misstatement would be clearly trivial that, if identified, would not need to be documented in the working papers or assessed in any way. If there is any doubt whether a particular misstatement is trivial, then it is likely not trivial.

Examples

Identify Material Balances

Based on the calculated materiality amount, the following items in the statement of financial position have been identified as being material for the purposes of the review engagement. These include inventory, revenues, expenses, receivables, payables, bank indebtedness, fixed assets, and a loan to a related party.

Apply in Planning

In planning the inquiries and analytical review procedures to be performed, this materiality amount will be communicated to the team members and used to assess the information obtained and to identify any other areas where material misstatements are likely to arise.

4.2-3 Revise

Paragraph	Requirement
44	**The practitioner shall revise materiality for the financial statements as a whole in the event of becoming aware of information during the review that would have caused the practitioner to have determined a different amount initially. (Ref. Para. A74)**

In most engagements, the initial assessment of materiality will remain unchanged. In some situations, however, there may be a change in circumstances or new information obtained that would require a revision to the initial level of materiality. An example may be unexpected operating results that are substantially different from the anticipated period-end financial results.

Example

Saigeni is a company that makes software applications for smartphones. Materiality was initially determined at €12,000 based on user needs and budgeted income before taxes for the current year. However, one particular software application was extremely successful during this year and company sales and profitability were double the budgeted amount used for the initial materiality calculation. In light of this new information, the practitioner decided to revise the materiality amount from €12,000 to €24,000.

4.3 UNDERSTAND THE ENTITY

Paragraph	Requirement
	The Practitioner's Understanding
45	**The practitioner shall obtain an understanding of the entity and its environment, and the applicable financial reporting framework, to identify areas in the financial statements where material misstatements are likely to arise and thereby provide a basis for designing procedures to address those areas. (Ref: Para. A75–A77)**

4.3-1 Why?

Until an understanding of the entity is obtained, the practitioner is not in a position to identify where material misstatements are likely to arise or to design suitable procedures (inquiry and analytical procedures). A summary of the requirements to obtain an understanding, including the reasons why, is illustrated in the following exhibit.