An Example of Materiality

**LO 3-12**

In this example, the three steps for applying materiality are discussed using financial information for EarthWear Clothiers for the year ended December 31, 2015. This financial information is taken from the case illustration included in Chapter 1.

**Step 1: Determine the Overall Materiality**EarthWear Clothiers' income before taxes is $36 million (rounded). Assume that the auditors, Willis & Adams, have decided that 5 percent of this benchmark is appropriate for overall materiality. Thus, they determine overall materiality to be $1,800,000 ($36,000,000 × .05). To determine the final amount for materiality, the auditors should consider whether any qualitative factors (i.e., close to violating a covenant in a loan agreement) are relevant for the engagement. In our example, assume that the auditors have determined that no qualitative factors are relevant and that the $1,800,000 will be used for overall materiality. This is the amount that is used for determining tolerable misstatement for specific accounts or disclosures in Step 2.

Page 89

**Step 2: Determine Tolerable Misstatement**We assume that EarthWear's auditors determine tolerable misstatement by using 50 percent of overall materiality. Therefore, tolerable misstatement is $900,000 ($1,800,000 × .50).

**Step 3: Evaluate Audit Findings**Tolerable misstatement can be used for determining the fair presentation of the individual accounts after completion of the audit work. Assume that during the course of the audit the auditor identified two misstatements. The misstatements are compared to the tolerable misstatement allocated to each account. For example, the (**1**) first misstatement indicates a factual misstatement in the accrual of payroll expense and bonuses. The total misstatement of accrued payroll is $215,000. The (**2**) second entry is based on the results of a statistical sampling application for inventory. The statistical results indicated there is a misstatement of $312,500. In this example, no error is larger than the tolerable misstatement amount of $900,000, and the total of the misstatements is also less than overall materiality. Before making a final decision, the auditor should consider the possibility of undetected misstatements, further possible misstatements that may be due to sampling, and misstatements that carry forward from the prior year. The auditor should document his or her conclusion as to whether the aggregated misstatements cause the financial statements to be materially misstated (see Exhibit 3-3). If one of the entries were in excess of the tolerable misstatement for an account balance, or if the aggregated misstatements were greater than overall materiality, the entity would have to adjust the financial statements or the auditor would have to issue a qualified or adverse opinion.