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# A Forensic Accountant's Take on Materiality

February 20, 2020

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In the accounting profession, the concept of materiality in financial reporting comes from two distinct areas: Generally accepted accounting principles (GAAP), and generally accepted auditing standards (GAAS). Accounting principles focus on the criteria for measuring and disclosing the effects of business transactions on an entity's financial position and operations results. Auditing standards ultimately focus on whether the auditor can express an opinion, with reasonable assurance, that the financial statements are presented fairly.

## Materiality Concept Inherent in GAAP

The Financial Accounting Standards Board, the rulemaking body that determines GAAP, states in Financial Accounting Concepts No. 8 that "information is material if omitting it or misstating it could influence decisions that users make on the basis of the financial information of a specific reporting entity … materiality is an entity-specific aspect of relevance … [c]onsequently the Board cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation."

The materiality concept is inherent in financial reporting, as becomes apparent when considering the significant extent to which the preparation of timely financial statements requires estimates, judgments, and models rather than exact depictions. Examples include: (a) revenues based on the percentage of contract work completed; (b) accounts receivable that will not be collected; (c) decline in realizable value of inventory; (d) impaired value of financial assets or intellectual property; (e) liability for product returns or warranty work related to sales during the year; and (f) liabilities that are contingent on future results. Accounting principles require that estimates, judgments, and models have a reasonable basis, which is a fact-specific criteria.

## Materiality Concept Applied in GAAS

Generally accepted auditing standards require that the auditor determine – and document in its work papers – a materiality level used in designing and evaluating the results of audit procedures, and in concluding whether it has obtained reasonable assurance based on its audit procedures, that the financial statements are presented fairly, in all material respects. Auditing standards emphasize that materiality is a matter of professional judgment, including consideration of technical issues such as the concept of audit risks, which are extensively discussed in the professional literature.

The materiality level determined by the auditor does not necessarily establish a firmly fixed threshold below which all adjustments to correct misstatements are rejected. Auditing standards require that the auditor apply judgment as to whether there are any qualitative factors that would cause an adjustment below the quantitative materiality level to be considered material.

## Audit Materiality Benchmarks

Generally, the starting point for an auditor's approach to determining materiality is to identify entity specific financial statement benchmarks and select percentages within a reasonable range, for example:

| Income Statement Benchmarks | Potential Reasonable Range |
|---|---|
| Pre-tax Net Income From Operations | 5% to 10% |
| Revenues | 0.5% to 2.5% |

| Balance Sheet Benchmarks | Reasonable Range |
|---|---|
| Assets | 0.5% to 2.5% |
| Equity | 1% to 5% |

The relevance of each benchmark is considered for each company and may change from year to year based on consideration of the entity, its industry, and business and financial characteristics, including:

- The nature of the entity, where the entity is in its life cycle, and the industry and economic environment in which the entity operates
- The entity's ownership structure and the way it is financed (for example, 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)
- The relative volatility of the benchmark

The auditor's work papers will document the methodology and judgment it applied and the amount it determined as the materiality level for planning purposes. The auditor's work papers will also document the individual and aggregate amount of adjustments, by classification, for example:

- Waived Adjustments: Adjustments above a de minimis level and below a selected cut-off level: The auditor would consider if the aggregate effect of these adjustments is material; if the aggregate were material, the items would be included with the proposed adjustments.
- Proposed Adjustments: Adjustments above the cut-off level: Generally the auditor would present these adjustments to management and they would be recorded in the company's books and reflected in its financial reporting; if management elected not to record an item, the auditor would consider whether the impact is material. The auditor could require that the adjustment be recorded to provide an opinion that the financial statements are fairly stated.

## Materiality Concept in Post-M&A Claims

To illustrate how the materiality level determined by the auditor may become relevant to post-M&A transaction issues consider this example:

Target-Co is acquired for $30 million in August 2017 based on trailing 12-month earnings derived by the buyer based on audited financial statements for 2016 and unaudited financial statements through June 2017.

Post-transaction, the buyer claimed that, as a result of misstatements in the financial statements with an aggregate effect of reducing assets and earnings by $1 million, the seller breached its financial statement representations and warranties as to: fairly stated in all material respects based on GAAP consistently applied.

The audit work papers for the 2016 financial statements show that: (a) materiality level was $2 million; (b) the waived adjustments had a cumulative positive impact on earnings of $500,000 (attributable to the over-statement of certain reserves)

Depending on analysis of the qualitative factors referenced in the professional literature, as discussed above, there may be sufficient basis to establish that the financial statements provided by the seller were fairly stated because the misstatements' impact was not material. In addition, the positive impact of the auditor's waived adjustments would, in this example, be used to reduce the buyer's alleged misstatement.

On a final note, it is useful to highlight that in this example, and in most M&A transactions, the earnings which the buyer considered in its valuation of the company were not earnings reported in a financial statement provided by the seller. The trailing 12-month earnings were derived by the buyer from the seller's financial statements. The buyer's process and conclusions in developing its own measure of earnings must be considered quite carefully. This topic will be addressed in a future article.

The views and opinions expressed in this article are those of the authors and do not necessarily reflect the opinions, position, or policy of Eisner Amper or its other employees and affiliates.

About Andrew C. Bernstein: Andrew is a director in the forensic, litigation and valuation services group. He has over 30 years of experience in providing expert testimony and forensic accounting services. Andrew has provided expert testimony on economic damages, valuation and business issues in complex business disputes. He has testified in a range of venues including federal district court, federal bankruptcy court, state court, Delaware Chancery Court, and international arbitration.

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