Assignment 2: Calculate materiality

W/P ref: A2–1
Prepared by: _____
Date prepared: _____

Cloud 9 Ltd.
December 31, 2014

Setting materiality

Users	Financial statement area of most concern to the user
Cloud 9 Inc.	This is the parent company of Cloud 9 Ltd. They are concerned with the company's ability grow its market share of the North American footwear market. This would best be reflected by revenues.
Bank	Concerned with the ability of Cloud 9 to repay borrowed funds. As a result, it is mostly concerned with net income as this is the best predictor of an entity's future ability to repay.
Management	Concerned primarily with revenues as this is the basis for their bonuses.

Base selected for planning materiality (PM): ________________________________
Justification for selection:

Revenue is the most appropriate basis for calculating PM. This is the preferred method because:

- Cloud 9 is currently in a loss for the year ended December 31, 2014; therefore, net income before tax is not an appropriate basis.
- The parent entity (main users of the accounts) is concerned with increasing the market share of the Canadian market—essentially revenue.
- Management has an incentive to manipulate revenue based on growth targets expected and compensation attached to meeting those targets.

Calculation of PM

	Current Year	Prior Year
Trial balance amount:	$ 37,194,932	$ 34,038,192
Normalizing adjustments (that is, non-recurring items)	$ 0	$ 0
Annualized (if required):	NA; full-year balances used	NA; full-year balances used

Benchmark applied	0.5% of revenues
Calculated materiality:	$ 37,194,192 × 0.5% = $185,975

Conclusion: PM materiality is $185,000 (rounded).

Performance materiality: 60% × $185,000 = $111,000.
Conclusion: Performance materiality is ____$111,000_____.

Discussion points
Consider how you will use the planning materiality in your audit. What factors might lead you to increase or decrease the planning materiality amount?

NOTE TO THE LECTURER:
Additional discussion points

How would the planning materiality be used?

- To compare fluctuations in (annualized) accounts between years, those with fluctuations greater than materiality may need greater attention.
- In the allocation of resources within the audit, those accounts with greater levels of inherent risk and more material accounts may receive more audit hours.

What would lead the auditor to increase or decrease materiality?

- There could be uncertainty in the external environment. For example, during the global financial crisis, auditors may have been more conservative and decreased the level of materiality to ensure detection of material misstatements.
- If this is a new audit client, the auditor may set materiality lower in the first year while gathering an understanding of the client. If no material misstatements are found in the first year, it may be increased on subsequent audits.