

What is the Materiality Principle?

Worksheet

Materiality is the threshold at which an omission or misstatement in financial information would likely change the judgment of a reasonable user; amounts below it can be simplified or grouped, amounts above it must be reported accurately and separately.

Questions

1. An item is 'material' if:

- A) It is always over \$1,000,000
- B) Its omission could reasonably influence a user's decision
- C) It appears on the balance sheet
- D) It was audited

2. Net income is \$10,000,000. Using a 5% benchmark, what is the materiality threshold?

- A) \$50,000
- B) \$500,000
- C) \$5,000,000
- D) \$100,000

3. Which of these can make a small dollar amount material anyway?

- A) It's below the benchmark
- B) It involves fraud or illegal acts
- C) It's fully depreciated
- D) It's cash, not accrued

4. Materiality mainly affects:

- A) Tax rates a company pays
- B) What must be separately disclosed in financial statements
- C) Stock price directly
- D) Employee salaries

5. A company has net income of \$4,000,000. Using a common 5% benchmark, what is its materiality threshold?

6. A firm discovers a \$15,000 bookkeeping error. Its total assets are \$50,000,000 (1% benchmark = \$500,000). Is the error material?

7. A small \$8,000 misstatement conceals that the CEO secretly received an unauthorized bonus. Is it material?

8. Define: What is the materiality principle?

9. Define: What's a common materiality benchmark?

10. Define: Is materiality only about dollar amounts?

Answer Key

1. B) Its omission could reasonably influence a user's decision - Materiality is about whether an omission or error could change a reasonable user's decision.
2. B) $\$500,000 - 10,000,000 \times 0.05 = \$500,000$.
3. B) It involves fraud or illegal acts - Qualitative factors such as fraud can make even a small amount material.
4. B) What must be separately disclosed in financial statements - Materiality determines the level of detail and disclosure required in financial reporting.
5. Base = net income = $\$4,000,000$ Benchmark = 5% Threshold = $4,000,000 \times 0.05 = \$200,000$ Any misstatement above roughly $\$200,000$ is likely material
6. Threshold = $50,000,000 \times 0.01 = \$500,000$ Compare error ($\$15,000$) to threshold ($\$500,000$) $\$15,000$ is far below $\$500,000$ The error is immaterial on a quantitative basis (still check qualitative factors)
7. Quantitative test: $\$8,000$ is tiny relative to most benchmarks - looks immaterial Qualitative test: it involves fraud and related-party misconduct Qualitative factors override the small dollar size The item is material and must be disclosed
8. An item is material if omitting or misstating it could reasonably affect a user's decisions.
9. Roughly 0.5%-5% of a base such as net income, revenue or total assets (varies by context).
10. No - qualitative factors like fraud or legal issues can make a small amount material.

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