



**INTERNATIONAL FEDERATION
OF ACCOUNTANTS**

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Agenda Item

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Committee: IAASB
Meeting Location: Toronto
Meeting Date: April 19-23, 2004

Materiality

Objectives of Agenda Item

To review and discuss the revised proposed exposure draft of ISA 320, “Materiality in the Identification and Evaluation of Misstatements.”

Because of the need to ensure consistency with the proposed revised ISA 540, “Auditing Accounting Estimates and Related Disclosures (Excluding Those Involving Fair Value Measurements and Disclosures),” which is being presented at this meeting for a first read, the Task Force is not asking the IAASB to approve the revised proposed exposure draft at this time.

In view of the significant number of changes made to the previous draft presented to the IAASB, the presentation and discussion of the revised proposed exposure draft will be based on the clean copy (Agenda Item N-A).

Task Force Members

The Task Force comprises members of both the IAASB and the Auditing Practices Board of the United Kingdom and Ireland. The members of the Task Force are:

Graham Ward (Chairman)	APB Vice Chairman
Arch Archambault	IAASB member
Denise Esdon	IAASB Vice Chair
Jon Grant	APB member and IAASB technical advisor
Diana Hillier	IAASB technical advisor
David Lindsell	Former APB member
Graham Pimlott	APB member
Roberto Tizzano	IAASB member

Denise Esdon and Diana Hillier became members of the Task Force after the July 2003 IAASB meeting.

Background

At the July 2003 IAASB meeting, the Task Force presented a first draft of the proposed exposure draft. At that meeting, in addition to detailed drafting points, the IAASB identified four main issues:

- The qualitative assessment of materiality when planning the audit.
- The discussion of users and their expectations.
- The identification of “differences of judgment” as a separate classification of misstatements.
- Obtaining representations from those responsible for approving the financial statements.

The IAASB also suggested that the Task Force explore in more detail the link between the proposed exposure draft and the Audit Risk ISAs.

Activities Since Last IAASB Discussions

The Task Force has met three times and held a conference call to consider how it should respond to the IAASB comments and to revise the proposed exposure draft. Significant changes have been made to the proposed exposure draft.

A draft of the document has been sent to the SMP Task Force and the Public Sector Committee. Comments have been received recently from the SMP Task Force and the Materiality Task Force will consider them at its next meeting.

THE QUALITATIVE ASSESSMENT OF MATERIALITY WHEN PLANNING THE AUDIT

The model presented by the Task Force in July 2003 was based on the determination of multiple levels of materiality. It recognized that users of audited financial statements may be more sensitive to misstatements in relation to certain classes of transactions, account balances and disclosures than in relation to others, and to the trends and ratios that may be derived from them. The auditor, in addition to considering materiality at the overall financial statement level, was required to consider whether there are particular classes of transactions, account balances and disclosures for which different, lower, levels of materiality are appropriate, both for planning and evaluating the results of audit procedures.

The IAASB, whilst having some support for the conceptual approach proposed by the Task Force was strongly concerned that it was not practicable (e.g. because it was felt that the auditor would not be able to determine what users would consider material at the account level; and taking account of qualitative factors when planning the audit could lead to the auditor being expected to plan audits to unreasonably low levels of materiality). There appeared to be a preference for a model that was broadly in line with what audit firms do at present. That is: to determine a single figure for materiality, on a primarily quantitative/formulaic basis, when planning the audit, for consideration of the financial statements as a whole, and setting lower levels of “tolerable error”¹ for planning audit tests. Misstatements subsequently identified would be evaluated on both a quantitative and qualitative basis, whether or not they are lower than planning materiality.

Different audit firms have different methods for calculating “tolerable error” (and also use different terms for it). For example, some determine a single amount for use in testing all account balances, others determine separate amounts that may be in proportion to the size of the account balances. The determination is often based on a percentage of materiality, where the percentage used is related to an estimate of the risk of error (lower percentages are used where the risk of

¹ “Tolerable error” is defined in ISA 530, “Audit Sampling and Other Selective Testing Procedures” as “the maximum error in a population that the auditor is willing to accept.”

expected misstatement is considered to be higher). The exercise of judgment in setting tolerable error is important.

In response to the concerns, the Task Force has revised the proposed exposure draft as follows:

- The section on determining materiality (paragraphs 11 to 20) starts by clarifying that the auditor should determine a materiality level for the financial statements taken as a whole.

As in the previous draft there is an indication that the auditor may base the determination of materiality on an appropriate benchmark, and discussion of the considerations when identifying such a benchmark. The Task Force has not suggested a simple formulaic approach to setting materiality as it believes that it is based on professional judgment, taking account of the nature and circumstances of the entity.

- There is no longer an indication that the auditor considers whether there are particular classes of transactions, account balances and disclosures for which different lower levels of materiality are appropriate for use in planning, and evaluating, audit procedures, resulting typically in more than one level of materiality being established.

The Task Force, however, does believe that it is important that the auditor should consider whether, in the specific circumstances of the entity, misstatements of particular items of lesser amounts than the materiality level, if any, determined for the financial statements taken as a whole, would in the auditor's judgment, reasonably change or influence economic decisions of users taken on the basis of the financial statements as a whole (e.g. disclosures of related party transactions). Accordingly a bold text requirement to this effect is included (paragraph 12) and further guidance is provided in paragraphs 17 and 18. The Task Force believes that this is consistent with current best practice.

THE DISCUSSION OF USERS AND THEIR EXPECTATIONS

There were concerns in July 2003 that the proposed exposure draft went too far in considering who are the users to whom the auditor has regard and may have been taken to suggest that the auditor should judge the specific needs of different classes of user when determining materiality. The Task Force was advised to liaise with the Auditor's Report Task Force which was considering conforming changes to ISA 200, "Objectives and General Principles Governing an Audit of Financial Statements" that would address users of audited financial statements.

The Task Force liaised with members of the Auditor's Report Task Force as advised. The final exposure draft of conforming changes to ISA 200, which was approved by the IAASB and issued in December 2003, however, does not include any guidance on who are the users of financial statements that the Materiality Task Force believes it could helpfully use or refer to in the proposed revised ISA 320.

The Task Force has simplified the guidance on users (paragraphs 6 and 7) and believes that it has addressed the IAASB's concerns.

THE IDENTIFICATION OF "DIFFERENCES OF JUDGMENT" AS A SEPARATE CLASSIFICATION OF MISSTATEMENTS.

At the July 2003 meeting there were concerns about identifying misstatements arising from differences in judgment as a separate classification of misstatements. The Task Force was asked to clarify the guidance in the proposed exposure draft.

The Task Force has revised the guidance; in particular to clarify that:

- The category only includes differences in judgment that the auditor considers to be misstatements, and not all differences of judgment (paragraph 8(c)).
- Differences in judgment relating to the application of accounting policies that the auditor considers to be misstatements are those where the auditor considers an accounting policy selected and applied by the entity to be inappropriate (paragraph 8(c)).
- Materiality is determined without regard to the degree of inherent uncertainty associated with the measurement of particular items. For example, if the financial statements include very large provisions with a high degree of measurement uncertainty (e.g. for insurance claims in the case of an insurance company, oil rig decommissioning costs in the case of an oil company, or, more generally, legal claims against an entity) the auditor does not determine that the materiality level for the financial statements taken as a whole is higher than the level that would be determined if the financial statements did not include such measurement uncertainties in relation to those provisions (paragraph 14).

Although the auditor must determine the specific amount of a misstatement arising from a difference in judgment, the process of determination is generally far more subjective than in the case of known misstatements. Some members of the Task Force have practical experience of separately classifying misstatements arising from differences in judgment. Their experience is that audit committees typically find it helpful for the auditor to distinguish such misstatements from factual errors when discussing the results of the audit. Also, a Research Study undertaken for the APB in 2003 on the subject of communication between auditors and audit committees, identified that a distinction between errors of “fact” and differences of opinion over accounting estimates and judgments was useful. The research included interviews of the audit committee chairmen, CFO’s and lead audit partners of some of the largest listed UK companies

OBTAINING REPRESENTATIONS FROM THOSE RESPONSIBLE FOR APPROVING THE FINANCIAL STATEMENTS.

At the July 2003 IAASB meeting, the Task Force highlighted that it felt strongly that those responsible for approving the issuance of the financial statements to the users should be the ones from whom the auditor obtains a representation that unadjusted misstatements are not material. Some members of the IAASB indicated that in practice it may be difficult to obtain representations from those persons rather than from “management” who have responsibility for preparing the financial statements.

The Task Force continues to believe that the representations should be sought from those who are responsible for approving the issuance of the financial statements, because they have legal responsibility for the financial statements and it provides greater assurance that they have considered the specific issues. Accordingly, no changes have been made to the proposed exposure draft in this respect.

As the Task Force indicated in June 2003 in a letter sent to the Chairman (included in the July 2003 IAASB Agenda Papers), some difficulties are being caused by the introduction into ISAs of the term “those charged with governance.” The split of responsibilities between management and those charged with governance is not always clear and is exacerbated by structures of governance varying from country to country and within different types of entity. The IAASB “Glossary of Terms” does not define either of these categories of individuals in a way that the Task Force would be comfortable to use as the basis for defining those from whom “management representations” should be obtained.

THE RELATIONSHIP BETWEEN MATERIALITY AND AUDIT RISK

A specific section on the relationship between materiality and audit risk has been included in the revised proposed exposure draft (paragraphs 9 and 10). This explains that materiality and audit risk need to be considered together throughout the audit.

Other Matters for the Attention of the IAASB

The Task Force also draws the following matters to the attention of the IAASB for consideration when reviewing the proposed exposure draft.

DEFINITION OF MATERIALITY

The existing definition of materiality in ISA 320 is taken from the International Accounting Standards Board's "Framework for the Preparation and Presentation of Financial Statements":

"Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful."

As was explained to the IAASB at its December 2002 meeting, the Task Force is concerned that this definition does not make clear the importance of considering the nature, as well as the size, of an item. A revised definition of materiality is given in paragraph 5 of the proposed exposure draft:

"The auditor should consider a misstatement, or an aggregate of misstatements, to be material if, in the judgment of the auditor, it is probable that the effect of the misstatement, or aggregate misstatements, would reasonably change or influence economic decisions, taken on the basis of the audited financial statements as a whole, by users who have a reasonable understanding of business, economic activities and financial reporting. In deciding whether a misstatement or an aggregate of misstatements is material, the auditor should consider both the size and nature of the misstatement or aggregate misstatements judged in the particular circumstances of their occurrence."

The Task Force notes that the revised International Accounting Standard 1 "Presentation of Financial Statements", issued in December 2003, contains the following new definition of materiality:

"Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor."

The new IASB definition is not inconsistent with the definition proposed by the Task Force. There may be some merit in adopting the new IASB definition in place of the one proposed by the Task Force. The Task Force, however, recommends the definition in paragraph 5 of the proposed exposure draft, as it is more clearly focused on audit considerations.

ALLOCATION OF MATERIALITY / TOLERABLE ERROR

As explained in the July 2003 IAASB Agenda Papers, the Task Force has considered whether the proposed exposure draft should address the concepts of the "allocation of materiality" and "tolerable error." These are methods whereby amounts lower than materiality are determined and used to plan audit procedures, allowing for the effects of aggregation of misstatements in different classes of transactions, account balances and disclosures, and for the possibility of misstatements that are not detected by the auditor. They also help facilitate the apportionment of work effort to different classes of transactions, account balances and disclosures.

In July 2003 the Task Force had concluded that these concepts would be more appropriately addressed in ISAs that relate to obtaining audit evidence (such as ISA 530, “Audit Sampling and Other Selective Testing Procedures,” which already addresses tolerable error, or the then proposed ISA 330, “The Auditor’s Procedures in Response to Assessed Risks”).

Following the discussions at the July 2003 IAASB meeting, the Task Force has reconsidered the issue and concluded that it would be appropriate to include some guidance on these matters in the proposed exposure draft, particularly as the final ISA 330 does not address them. Accordingly, a new section, “Assessing the Risks of Material Misstatement at the Assertion Level and Planning Further Audit Procedures,” has been developed (paragraphs 19 and 20).

The new guidance indicates that when assessing the risks of material misstatement at the assertion level, and designing and performing further audit procedures to respond to those assessed risks, the auditor allows for the possibility that misstatements of lesser amounts than the materiality level determined for the financial statements as a whole could, in the aggregate, result in a material misstatement of the financial statements. To make this allowance the auditor uses professional judgment to determine levels of “tolerable misstatement” for classes of transactions, account balances and disclosures. The level of tolerable misstatement for a particular class of transaction, account balance or disclosure cannot be higher than the materiality level that the auditor has determined for the financial statements as a whole or, if applicable, the lower materiality level determined for a particular class of transactions, account balance or disclosure, and ordinarily is lower.

The concept of “tolerable misstatement” is very similar to that of “tolerable error,” although the terms are not equivalent – “tolerable error” being used specifically in relation to tests of detail as described in ISA 530. A footnote has been included in the proposed exposure draft to distinguish the two terms.

The Task Force notes that the term “tolerable misstatement” is used in paragraph 51 of ISA 530. The last sentence thereof, reflecting the audit risk conforming changes, states:

“For tests of details, tolerable error is the tolerable misstatement, and will be an amount less than or equal to the auditor’s preliminary estimate of materiality used for the individual class of transactions or account balances being audited.”

The term “tolerable misstatement” is not used elsewhere in ISA 530 and is not defined therein. The Task Force believes that, given its proposed description of the term in revised ISA 320, it would not be correct to indicate that, for all tests of details, tolerable error is equal to tolerable misstatement (e.g. they may be different where a test of detail is only applied to part of a particular class of transactions or account balance). Accordingly, if the IAASB agrees to the use of the term in the proposed exposure draft as described above, the Task Force proposes that a conforming change be made to paragraph 51 of ISA 530 so that it states:

“For tests of details, tolerable error is may be equal to or less than the tolerable misstatement the auditor determined for the particular, ~~and will be an amount less than or equal to the auditor’s preliminary estimate of materiality used for the individual~~ class of transactions or account balances being audited.”

A footnote in ISA 530 would give a cross reference to ISA 320 to explain the term “tolerable misstatement.”

The Task Force debated whether the proposed exposure draft should set out in detail a formulaic approach for determining levels of tolerable misstatement. There was some support for this on the

grounds that it would introduce consistency to the methods used by different audit firms, but the majority of Task Force members felt that this would not be appropriate because:

- It would take the proposed exposure draft too far towards setting a methodology rather than auditing standards;
- It would not be consistent with the exercise of professional judgment; and
- The Task Force is not aware of any persuasive evidence that one of the methods used by different audit firms is better than the others or that the quality of audits performed by different firms is affected by the method used.

GROUPS

Following the July 2003 IAASB meeting, the Task Force was informed that it should include some guidance on the determination of materiality levels in relation to the audit of groups. Since then the IAASB has approved and issued an exposure draft of a proposed IAPS, "The Audit of Group Financial Statements," which includes guidance on the determination of materiality in relation to the audit of groups. The guidance in the proposed IAPS is based, as directed by the IAASB, on the existing guidance in ISA 320.

The Materiality Task Force agrees that the proposed IAPS is the appropriate pronouncement in which to present guidance on the determination of materiality levels in relation to the audit of groups. Agenda Paper N-C sets out suggested changes to the IAPS to conform it in due course with the proposed revised ISA 320.

COMMUNICATION WITH MANAGEMENT AND THOSE CHARGED WITH GOVERNANCE AND OBTAINING WRITTEN REPRESENTATIONS

Paragraphs 28 to 41 of the proposed exposure draft address the communication of materiality, misstatements and qualitative aspects of the entity's accounting practices to management and those charged with governance. Paragraphs 42 and 43 address the subject of obtaining written representations from those responsible for approving the issuance of the financial statements to the users (see above). These sections cover, inter alia, the standards and guidance in the extant ISA 240 that the Fraud Task Force identified need to be repositioned and, therefore, did not include in the main body of the revised ISA 240 but include, as conforming changes, in ISA 260, "Communication of Audit Matters With Those Charged With Governance," ISA 320 and ISA 580, "Management Representations." The wording in the proposed exposure draft of revised ISA 320 is different to that in the extant ISA 240 and would supersede the conforming additions to ISA 260 and ISA 580 made with the revised ISA 240.

The Task Force believes that, as an alternative to including them in the proposed exposure draft of revised ISA 320, paragraphs 28 to 41 could be added to ISA 260, and paragraphs 42 and 43 added to ISA 580. The detailed nature of the proposed standards and guidance, however, may not fit well in the existing ISA 260 and ISA 580 which are written at a relatively high level. The Task Force believes that the IAASB is considering, but has not yet concluded, whether ISA 260 and ISA 580 should be revised to be detailed standards or be overarching standards.

The Task Force asks the IAASB whether it believes that it is appropriate to include paragraphs 28 to 43 in the proposed exposure draft of revised ISA 320, or whether it believes they should be excluded and proposed as conforming additions to the existing ISA 260 and ISA 580. If the latter, the Task Force will revise the proposed exposure draft accordingly and present these paragraphs as conforming changes to ISA 260 and ISA 580.

EVALUATING THE OVERALL EFFECT OF AUDIT FINDINGS ON THE AUDITOR'S REPORT

The Task Force believes that, in addition to evaluating the effect of uncorrected misstatements, the auditor should evaluate whether there are qualitative aspects of the entity's accounting practices and financial reporting that cause the financial statements taken as a whole not to give a true and fair view (or present fairly, in all material respects). For example, the effects of bias in accounting estimates or the selection and application of accounting policies.

Paragraphs 40 and 41 address communication to those charged with governance of the auditor's views about the qualitative aspects of the entity's accounting practices and financial reporting. Paragraphs 48 to 57 address the evaluation of the overall effect of audit findings on the auditor's report.

The Task Force believes that the proposed standards and guidance are consistent with the guidance on forming an opinion on the financial statements in the proposed revised ISA 700, "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements," and the guidance in relation to accounting estimates in the proposed revised ISA 540.

CONSISTENCY WITH OTHER ISAS

The proposed exposure draft includes cross references to other ISAs that are in the process of being revised, in particular ISA 540. The Task Force is aware that these cross references will need to be updated in due course.

Material Presented

Agenda Paper 5-A (Pages 405–420)	Draft exposure draft - clean
Agenda Paper 5-B (Pages 421–446)	Draft exposure draft - mark-up (showing changes from the draft presented at the July 2003 IAASB meeting)
Agenda Paper 5-C (Pages 447-448)	Proposed conforming changes to the proposed IAPS, "The Audit of Group Financial Statement"

Action Requested

The IAASB is asked to review and comment on the proposed exposure draft to enable the Task Force to prepare a revised proposed exposure draft for approval for issue.