



**INTERNATIONAL FEDERATION  
OF ACCOUNTANTS**

545 Fifth Avenue, 14th Floor  
New York, New York 10017  
Internet: <http://www.ifac.org>

Tel: +1 (212) 286-9344  
Fax: +1 (212) 286-9570

## Agenda Item

# 9

**Committee:** IAASB  
**Meeting Location:** New Orleans  
**Meeting Date:** December 6-10, 2004

### Materiality

#### Objectives of Agenda Item

To review and approve for exposure the proposed revised ISA 320, "Materiality in the Identification and Evaluation of Misstatements."

#### 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:

David Lindsell (Chair)	Former APB member
John Archambault	IAASB member
Denise Esdon	IAASB Deputy Chair
Jon Grant	APB member and IAASB technical advisor
Diana Hillier	IAASB technical advisor
Graham Pimlott	APB member
Roberto Tizzano	IAASB member

#### Activities Since Last IAASB Discussions

The Task Force held conference calls on October 22 and November 3, 2004 to consider the comments it had received at the September 2004 IAASB meeting and make appropriate revisions to the exposure draft of the proposed revised ISA 320. Mr Sukanta Dutt, Chair of the Task Force revising ISA 800, "The Auditor's Report on Special Purpose Audit Engagements," participated in the conference call on October 22.

#### Significant Changes Made in Response to the IAASB's Comments

##### CONSIDERATION OF SPECIAL PURPOSE ENGAGEMENTS

The IAASB asked the Task Force to consider the appropriateness of the decision that the revised ISA need not give additional guidance in relation to special purpose audit engagements.

The Task Force has considered this decision and has made some changes. A sentence has been added to the end of paragraph 1 stating “The guidance in the ISA is to be adapted for audits of historical financial information other than financial statements”. A new paragraph 9 has been added stating that “When determining materiality in audits of financial statements or other historical financial information prepared for a special purpose, the auditor considers the needs of specific users in the context of the objective of the engagement.”

#### DEFINITION OF MATERIALITY

The IAASB agreed that it was appropriate to adopt the definition on materiality that is given in International Accounting Standard (IAS) 1 “Presentation of Financial Statements”. There was, however, concern that the expression “misstatements of items are material if they *could* ... influence ...” potentially set a very low bar for the determination of materiality. The Task Force was asked to develop the guidance further to explain the context in which “could” is used, drawing on the relevant guidance in IAS 1.

Other guidance in IAS 1 relating to materiality has been incorporated in paragraph 10. The opening sentence now states “The evaluation of whether a misstatement could influence economic decisions of users, and so be material, involves consideration of the characteristics of those users”. A list of assumed characteristics of users is then followed by the statement “The determination of materiality, therefore, takes into account how users with such characteristics could *reasonably* be expected to be influenced in making economic decisions.”

#### USERS

The IAASB asked the Task Force to provide further guidance explaining who “intended users” are and their characteristics; guidance in IAS 1, explaining the characteristics of users and the matters that could influence their economic decisions, should be used as the basis. The IAASB also asked the Task Force to provide brief guidance on the auditor’s duty of care.

Paragraph 8 has been amended to indicate that the auditor considers the needs of:

- The intended users of the auditor’s report; and
- Other users, if any, to whom the auditor has a legal responsibility

Footnote 3 states “Whether the auditor has a legal responsibility will depend on the circumstances of each case and the relevant jurisdiction.” This is consistent with the International Framework for Assurance Engagements.

The assumed characteristic of users set out in paragraph 10(a) is the same as that set out in IAS 1. (See also the comments above in relation to the definition of materiality.)

#### QUANTITATIVE GUIDELINES

The IAASB asked the Task Force to make more clear that the auditor needs to exercise judgment and may determine different percentages in different circumstances (i.e. that the examples given are just “examples” and not rules). It was thought that further examples may help achieve this.

The Task Force was provided with a few additional examples of quantitative guidelines used by a firm and a national standard setter. These included the use of sliding scales to determine materiality in some circumstances.

The Task Force felt that referring to sliding scales would not be helpful without going into more detail than was considered appropriate and that might give the impression of setting rules.

To clarify that the examples are just that, an explicit statement has been added after the examples in paragraph 14 that “The auditor may consider higher or lower percentages than those illustrated above to be appropriate.”

A further example, for a profit oriented owner managed entity, has been added in paragraph 14.

[The Task Force believes that if more practical guidance on methods of determining materiality is deemed necessary it would be more appropriately given in an IAPS.]

#### COMMUNICATION OF MISSTATEMENTS TO MANAGEMENT.

The IAASB asked the Task Force to clarify the requirements and guidance relating to the auditor encouraging management to correct all known misstatements (other than those that the auditor believes are clearly trivial), particularly in relation to ensuring that management does not “cherry pick” misstatements to correct when the auditor encourages management to take action to reduce the estimated amount of likely misstatements. In addition, the proposed ISA should explain that the auditor is to consider management’s reasons for refusing to correct such misstatements; the reasons should also factor into the auditor’s consideration of the qualitative aspect of materiality.

Paragraph 31 has been amended to indicate that the auditor *requests* management to correct misstatements, rather than just *encourage* management to do so. Paragraph 33 has been amended to state that “If management refuses to correct some or all of the misstatements communicated to it by the auditor, or identified when management examines a class of transactions, account balance or disclosure, the auditor obtains an understanding of management’s reasons for not making the corrections and takes that into account when considering the qualitative aspects of the entity’s accounting practices (see paragraph 39)”.

Paragraph 39 addresses qualitative aspects of the entity’s accounting practices considered by the auditor, including selective correction of misstatements by management.

#### UNDETECTED MISSTATEMENTS.

The IAASB asked the Task Force to include guidance indicating that the auditor needs to allow for undetected misstatements when performing the evaluation.

Paragraph 26 has been added which states “... If the aggregate of the misstatements that the auditor has identified approaches the materiality level, the auditor considers whether it is likely that undetected misstatements, when taken with the aggregate identified misstatements, could exceed the materiality level and, if so, reconsiders the nature and extent of further audit procedures.” This is based on paragraph 16 in the extant ISA 320.

**PRIOR PERIOD MISSTATEMENTS**

The IAASB asked that the proposed guidance should be amended such that it is neutral as to whether the rollover method or iron curtain method should be used.

The intention of the Task Force has always been to be neutral as to whether the rollover or iron curtain method should be used. The purpose of the paragraph that has caused confusion was to indicate that the appropriate treatment of misstatements relating to prior years is determined by the applicable financial reporting framework. The Task Force has concluded that it is best to remain silent on this issue and has deleted the paragraph (39 in the previous draft).

**MANAGEMENT BIAS**

The IAASB asked the Task Force to clarify the auditor's obligation(s) to consider management bias. In addition, the Task Force was asked to strengthen the link between management bias and the risk of material misstatement of the financial statements. The IAASB also felt that the concept of management bias may be clearer if the examples were not limited to accounting estimates.

This section has been completely rewritten and simplified (paragraphs 38 and 39) to address the IAASB's comments.

**Other Matters for the Attention of the IAASB****PUBLIC SECTOR PERSPECTIVE**

The PSC is reconsidering this wording on the basis of the current draft of the proposed revised ISA.

**CONFORMING CHANGES TO OTHER ISAS**

In light of the status of other projects the Task Force has concluded that the proposed revised ISA need not suggest conforming changes to ISA 260 "Communication of Audit Matters With Those Charged With Governance," ISA 580 "Management representations" or the Proposed IAPS "The Audit of Group Financial Statements." Accordingly the Appendix in the previous draft has been deleted.

**Material Presented**

Agenda Paper 9-A (Pages 2405-2416)	Proposed ISA 320 (Revised), "Materiality in the Identification and Evaluation of Misstatements" (Clean)
Agenda Paper 9-B (Pages 2417-2436)	Proposed ISA 320 (Revised), "Materiality in the Identification and Evaluation of Misstatements" (Mark-up)
Agenda Paper 9-C (Pages 2437-2438)	Proposed Explanatory Memorandum

**Note:** The proposed Explanatory Memorandum is not for discussion at the December 2004 IAASB meeting. IAASB members are invited to submit any comments that they may have to the responsible staff member before the conclusion of the meeting.

### **Action Requested**

The IAASB is asked to review and approve the proposed exposure draft for issue subject to such changes being made as the IAASB requests.

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