

## **Materiality in the Identification and Evaluation of Misstatements –Proposed Explanatory Memorandum**

This memorandum provides some background to, and an explanation of, the proposed revised International Standard on Auditing (ISA) 320, under a new title of “Materiality in the Identification and Evaluation of Misstatements,” approved for exposure by the International Auditing and Assurance Standards Board (IAASB).

### **Background**

Since the issuance of ISA 320, “Audit Materiality,” several national standard setters have revised and expanded their existing standards and guidance. There is increased recognition in particular of the need for greater consideration of the nature of items, as well as their size, and the circumstances of the entity when determining materiality and evaluating misstatements. Work undertaken by the United Kingdom’s Auditing Practices Board (UK APB) on aggressive earnings management also highlighted audit materiality as an important area. In light of this, the IAASB approved a project for a comprehensive revision of ISA 320 and a joint Task Force was established comprising members of the IAASB and the UK APB.

### **Significant Proposals**

#### THE DEFINITION OF MATERIALITY

The proposed revised ISA 320 includes a new definition of materiality that makes clear that materiality depends on the size and nature of an item judged in the surrounding circumstances. The new definition is the same as that in International Accounting Standard (IAS) 1, “Presentation of Financial Statements,” issued by the International Accounting Standards Board (IASB). The proposed revised ISA 320 also makes clear that if the applicable financial reporting framework includes a different definition of materiality the auditor considers whether that definition includes other factors that are relevant to the auditor’s determination of materiality.

#### USERS

Materiality in the context of an audit relates to the auditor’s judgment of the needs of users in relation to the information in the financial statements and the possible effect of misstatements therein. For an audit of general purpose financial statements, it is not practicable for the auditor to obtain and take account of an understanding of the expectations of all the possible individual users of the financial statements. The proposed revised ISA 320 indicates that, for an audit of general purpose financial statements, the auditor has regard to the intended users for whom the auditor prepares the auditor’s report and other users, if any, to whom the auditor has a legal responsibility. The auditor considers these users as a group, not individually.

#### DETERMINING MATERIALITY

The proposed revised ISA 320 introduces guidance on the use of benchmarks and percentage numerical thresholds for the initial determination of materiality for the financial statements as a whole when establishing the overall audit strategy. This guidance is not, however, intended to set

formulaic rules for the determination of materiality; it makes clear that in practice the auditor selects measures that the auditor judges that users are most likely to consider important.

The proposed revised ISA 320 also requires that, when establishing the overall audit strategy, the auditor considers whether, in the specific circumstances of the entity, misstatements of particular items of lesser amounts than the materiality level determined for the financial statements as a whole, if any, could, in the auditor's judgment, reasonably be considered material by the users of the financial statements (e.g. in relation to disclosures of related party transactions and the remuneration of management and those charged with governance).

#### COMMUNICATION TO MANAGEMENT

The proposed revised ISA 320 requires the auditor to communicate all misstatements identified during the audit, other than those that the auditor believes are clearly trivial, to management and to request management to correct those misstatements. The IAASB believes that it is important to promote the development of an environment in which the correction of known misstatements is seen as the appropriate course of action, regardless of whether they are evaluated as material or not. Such an approach will also help to remove the difficulties that can arise in relation to the impact on current period financial statements of uncorrected prior period misstatements.

#### EVALUATION OF UNCORRECTED MISSTATEMENTS

The guidance in the proposed revised ISA 320 makes clear that determining materiality levels does not establish thresholds below which identified misstatements are always considered to be immaterial when evaluating those misstatements and their effect on the auditor's report. The circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are of a lower level than the auditor had determined to be material when establishing the overall audit strategy. Examples are given of such circumstances.

The guidance also indicates that during the audit, the auditor is alert for the possibility that management's judgments may be biased and that the cumulative effect of such a lack of neutrality, together with uncorrected misstatements that have been identified during the audit, may cause the financial statements as a whole to be materially misstated. Examples are given of indicators of a lack of neutrality in management's judgments that the auditor takes into account.

#### **Commentators Guide and Consideration of Specific Issues**

The IAASB welcomes comments on the proposed revised ISA 320. In responding to the proposed pronouncement, commentators are requested to refer to the relevant paragraphs within the pronouncement. The responses should include the reasons for the comments, including specific suggestions for any proposed changes to wording.

The IAASB is seeking comments on all matters addressed in the exposure draft. In addition the IAASB is interested in comments on matters discussed in this Explanatory Memorandum.