

The Auditor's Consideration of Management's Materiality

The Task Force has carried out a detailed review of ED- ISA 315(Redrafted) *Understanding the Entity and its Environment and Assessing the Risk of Material Misstatement* (ED-ISA 315) to assess whether the requirements and guidance within the ISA are sufficient, or whether an explicit reference to management's materiality should be inserted by way of a conforming amendment (or amendments).

ED-ISA 315 deals implicitly with the auditor's required understanding and assessment of management's attitude towards materiality in the context of internal control and fair presentation of the financial statements in the following paragraphs.

The Required Understanding of the Entity, Including Its Internal Control, and Its Environment

12. The auditor shall obtain an understanding of the following:

- (a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework (Ref: Para. A15-A20)

A17. *Relevant regulatory factors include the regulatory environment. The regulatory environment encompasses, among other matters, the applicable financial reporting framework and the legal and political environment.*

(b) ...

- (c) The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall consider whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry. (Ref: Para. A24)

A24. *An understanding of the entity's selection and application of accounting policies encompasses such matters as:*

- *The methods the entity uses to account for significant and unusual transactions.*
- *The effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.*
- *Changes in the entity's accounting policies.*
- *Financial reporting standards and regulations that are new to the entity and when and how the entity will adopt such requirements.*

13. The auditor shall obtain an understanding of internal control relevant to the audit. An understanding of internal control assists the auditor in identifying types of potential misstatements and factors that affect the risks of material misstatement, and in designing the nature, timing, and extent of further audit procedures. (Ref: Para. A38-A54)

A39. *Internal control is the process designed and put in place by those charged with governance, management, and other personnel to provide reasonable assurance about the achievement of entity's objectives with regard to:*

- *Reliability of financial reporting; ...*

A44. *Further, in designing and implementing controls, management may make informed judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.*

14. Ordinarily, controls that are relevant to an audit pertain to the entity’s objective of preparing financial statements for external purposes and the management of risk that may give rise to a material misstatement in those financial statements. Relevant controls may exist in any of the components of internal control. The auditor’s primary consideration is whether, and how, a specific control, individually or in combination with others, prevents, or detects and corrects, material misstatements in classes of transactions, account balances, or disclosures, and their related assertions. (Ref: Para. A55-60)

17. In understanding the entity’s internal control relevant to the audit, the auditor shall obtain an understanding of the following components of internal control:

(a) ...

(b) The entity’s process, whether formal or informal, for:

(i) identifying business risks relevant to financial reporting objectives;

(ii) estimating the significance of the risks;

(iii) assessing the likelihood of their occurrence; and

(iv) deciding about actions to address those risks;

and the results thereof. This process is defined as the “entity’s risk assessment process” and forms the basis for how management determines the risks to be managed. If the entity’s risk management process is appropriate to the circumstances, it assists the auditor in identifying risks of material misstatement.

In obtaining this understanding, the auditor shall inquire about business risks that management has identified and consider whether they may result in material misstatement. Where the auditor identifies risks of material misstatement that management failed to identify, the auditor shall consider whether there was an underlying risk of a kind that should have been identified by the entity’s risk assessment process. If there is such a risk, the auditor shall consider why that process failed to identify it and whether the process is appropriate to its circumstances. If, as a result, the auditor judges that there is a material weakness in the entity’s risk assessment process, the auditor shall communicate it to those charged with governance

(c) The information system, including the related business processes, relevant to financial reporting, and communication, as follows:

(i) The auditor’s understanding of the information system relevant to financial reporting, which shall be obtained by performing risk assessment procedures that include tracing transactions through the information system, shall include the following areas:

- The classes of transactions in the entity’s operations that are significant to the financial statements ...

- How the information system captures events and conditions, other than transactions, that are significant to the financial statements ...
- The financial reporting process used to prepare the entity’s financial statements, including significant accounting estimates and disclosures.... (Ref: Para. A74-78)

A74. *The information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures and records designed and established to:*

.....

- *ensure information required to be disclosed by the applicable financial reporting framework is accumulated, recorded, processed, summarized and appropriately reported in the financial statements.*

(d)

(e) *The major types of activities that the entity uses to monitor internal control over financial reporting, including those related to those control activities relevant to the audit, and how the entity initiates corrective actions to its controls. The auditor shall obtain an understanding of the sources of the information related to the entity’s monitoring activities, and the basis upon which management considers the information to be sufficiently reliable for the purpose. (Ref: Para. A87-A90)*

A89. *Much of the information used in monitoring may be produced by the entity’s information system. If management assumes that data used for monitoring are accurate without having a basis for that assumption, errors may exist in the information, potentially leading management to incorrect conclusions from its monitoring activities. Accordingly, an understanding of the sources of information related to the entity’s monitoring activities, and the basis upon which management considers the information to be sufficiently reliable for the purpose, is important for the auditor’s evaluation of the design of the entity’s monitoring activities as a component of internal control.*

Appendix 1

3. *For financial reporting purposes, the entity’s risk management process includes how management identifies business risks relevant to the preparation of financial statements that give a true and fair view (or are presented fairly, in all material respects) in accordance with the entity’s applicable financial reporting framework, estimates their significance, assesses the likelihood of their occurrence, and decides upon actions to respond to and manage them and the results thereof. For example, the entity’s risk assessment process may address how the entity considers the possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the financial statements.*

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