

MARKED FROM ED TEXT

PROPOSED INTERNATIONAL STANDARD ON AUDITING 320 (REVISED)

MATERIALITY IN PLANNING AND PERFORMING AN AUDIT

(Effective for audits of financial statements for periods beginning on or after [date])

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International Standard on Auditing (ISA) 320 (Revised), “Materiality in Planning and Performing an Audit,” should be read in the context of the “Preface to the International Standards on Quality Control, Auditing, Assurance and Related Services,” which sets out the application and authority of ISAs.

Introduction

1. ~~The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on materiality and how it is used in the identification and evaluation of misstatements when performing an audit of financial statements. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the determination of materiality and its application in planning and performing an audit of financial statements. How materiality is used in evaluating misstatements identified when performing an audit of financial statements is addressed in ISA XXX, “Evaluation of Misstatements Identified During the Audit.”~~ ~~The standards and guidance in the ISA are to be adapted for audits of historical financial information other than financial statements.~~
2. **The auditor should consider materiality when planning and performing the audit to reduce audit risk to an acceptably low level that is consistent with the objective of an audit.**
3. ISA 200, “Objective and General Principles Governing an Audit of Financial Statements,” requires the auditor to plan and perform the audit to reduce audit risk to an acceptably low level that is consistent with the objective of an audit. Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risk of material misstatement of the financial statements and the risk that the auditor will not detect such misstatement. ~~ISA 315, “Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement,” requires the auditor to identify and assess the risks of material misstatement at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures. ISA 330, “The Auditor’s Procedures in Response to Assessed Risks,” requires the auditor to design and perform further audit procedures in response to assessed risks. To do so, the auditor considers materiality: Materiality and audit risk are considered throughout the audit, in particular, when:~~
 - (a) ~~When i~~Identifying and assessing the risks of material misstatement (~~see ISA 315, “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatements”~~);
 - (b) ~~When d~~Determining the nature, timing and extent of further audit procedures (~~see ISA 330, “The Auditor’s Procedures in Response to Assessed Risks”~~); and
 - (c) ~~When e~~Evaluating the effect of ~~identified~~ uncorrected misstatements¹ on the financial statements and the related auditor’s report (~~see ISA XXX~~).

Materiality in the Context of an Audit

4. ~~As stated in ISA 200, the objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. The auditor is concerned with misstatements that either individually or in the aggregate could be material to the financial~~

¹ ~~Uncorrected misstatements are misstatements that the auditor has accumulated during the audit and that management has not corrected.~~

statements. The auditor therefore plans and performs the audit to obtain reasonable assurance that material misstatements are detected.

5. The auditor's consideration of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements. For the purposes of the audit, the auditor is concerned with misstatements, including omissions, which could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. In this context, it is reasonable for the auditor to assume that users:

- (a) Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;
- (b) Understand that financial statements are prepared and audited to levels of materiality;
- (c) Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and
- (d) Make reasonable economic decisions on the basis of the information in the financial statements.

~~6. Materiality can be defined in the following terms:~~

~~“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.”²~~

6. Furthermore, the auditor's consideration of materiality is based on the common financial information needs of users as a group; the auditor does not consider the possible effect of misstatements on specific individual users, whose needs may vary widely.³

7. Materiality depends on the size and nature of the misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.

78. If the applicable financial reporting framework ~~provides a different~~ contains a definition of materiality, ~~the auditor uses that definition for the purpose of the audit~~ it provides a frame of reference to the auditor when determining materiality for planning and performing the audit. Many financial reporting frameworks that define materiality include the concepts described in

² ~~As defined in International Accounting Standard (IAS) 1, “Presentation of Financial Statements.” In the ISAs, misstatements are considered to include omissions.~~

³ For example, the International Accounting Standards Board's “Framework for the Preparation and Presentation of Financial Statements” indicates that, for a profit oriented entity, as investors are providers of risk capital to the enterprise, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy.

paragraphs 5-6 and, accordingly, the auditor's judgment as to what would be material in the circumstances is not expected to vary significantly.

Users

- ~~8. The evaluation of whether a misstatement could influence economic decisions of users, and so be material, involves consideration of the characteristics of those users. Users are assumed to:~~
- ~~(a) Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;~~
 - ~~(b) Understand that financial statements are prepared and audited to levels of materiality and that there is a relationship between the level of materiality used and the cost and timing of the audit;~~
 - ~~(c) Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and~~
 - ~~(d) Make reasonable economic decisions on the basis of the information in the financial statements.~~

~~The determination of materiality, therefore, takes into account how users with such characteristics could reasonably be expected to be influenced in making economic decisions.~~

- ~~9. In an audit of general purpose financial statements, the auditor's judgment as to matters that are material to users of financial statements is based on consideration of the needs of users as a group; the auditor does not consider the possible effect of misstatements on specific individual users, whose needs may vary widely. The International Accounting Standards Board's "Framework for the Preparation and Presentation of Financial Statements" (the IASB's Framework) indicates that, for a profit oriented entity, as investors are providers of risk capital to the enterprise, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy. In the audit of such entities, therefore, the collective needs of investors as a group is an appropriate frame of reference when determining materiality.~~
- ~~10. 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.~~

Determining Materiality ~~for the Financial Statements as a Whole~~ when Planning the Audit

Materiality Level for the Financial Statements as a Whole

- ~~19. **When establishing the overall audit strategy,** ~~T~~**he auditor should determine a materiality level for the financial statements as a whole for ~~the~~ purposes of:**~~
- ~~(a) Determining the nature, timing and extent ~~and nature~~ of risk assessment procedures;~~
 - ~~(b) Identifying and assessing the risks of material misstatement; and~~

(c) **Determining the nature, timing and extent of further audit procedures.**

~~1210. The auditor determines a materiality level for the financial statements as a whole when establishing the overall audit strategy for the audit (see ISA 300 (Revised), “Planning an Audit of Financial Statements”). Determining a materiality level for the financial statements as a whole helps to guide the auditor’s judgments in identifying and assessing the risks of material misstatements and in planning the nature, timing and extent of further audit procedures. This materiality level does not, however, establish a threshold 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 below the materiality level determined when establishing the overall audit strategy. Although the auditor is alert for misstatements that could be material because of their nature, it ordinarily is not practical to design audit procedures to detect such misstatements. As discussed in paragraph 37, the circumstances related to some identified misstatements may cause the auditor to evaluate them as material even if they are below the materiality level determined when establishing the overall audit strategy. As discussed in ISA XXX, the auditor considers the nature and size of a misstatement, or aggregate of misstatements, judged in the surrounding circumstances, when evaluating its effect on the financial statements and the related auditor’s report.~~

Use of ~~Percentages of Benchmarks~~ in Determining Materiality

~~1311. The determination of Determining what is material to the users of the financial statements is a matter requires the exercise of professional judgment. The auditor often applies a percentage to a chosen benchmark as a step starting point in determining a materiality level for the financial statements as a whole.~~

12. When identifying an appropriate benchmark, the auditor has regard to factors such as:

- The elements of the financial statements (e.g., assets, liabilities, equity, income, ~~and expenses~~) ~~and the financial statement measures defined in the applicable financial reporting framework (e.g., financial position, financial performance and cash flows), or other specific requirements of that framework;~~
- Whether there are ~~financial statement~~ items on which the attention of the users of, for the particular entity’s financial statements, users’ attention tends to be focused (e.g., for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);
- The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which ~~it~~ the entity operates; ~~and~~
- The size of the entity, nature of its ownership and the way it is financed (e.g., if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity’s earnings); and
- The relative volatility of the benchmark.

13. ~~Examples of benchmarks that might may be appropriate, depending on the nature and circumstances of the entity, include categories of reported income such as profit before tax, total revenues, gross profit and other categories of reported income, such as profit before tax from continuing operations and total expenses, total equity or net asset value. Profit before tax from continuing operations may be a suitable benchmark is often used for profit-oriented entities, but may not be an appropriate benchmark for the determination of materiality when, for example, the entity's earnings are volatile, when the entity is a not-for-profit entity or when it is. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues. When an entity's profit before tax from continuing operations is consistently nominal, as might be the case for an owner-managed business where the owner takes much of the pre-tax income out of the business profit before tax in the form of remuneration, a benchmark such as profit before remuneration and tax may be more relevant. For asset-based entities (e.g., an investment fund) an appropriate benchmark might be net assets.~~
14. ~~Having identified an appropriate benchmark, the auditor identifies relevant financial data to be used in determining materiality. The auditor ordinarily considers prior periods' financial results and financial positions, the period-to-date financial results and financial position, and budgets or forecasts for the current period, taking account of significant changes in the circumstances of the entity (e.g., a significant business acquisition) and relevant changes of conditions in the industry or economic environment in which the entity operates. For example, when the auditor, as a starting point, determines materiality for a particular entity based on a percentage of profit before tax from continuing operations, circumstances that give rise to an exceptional decrease or increase in such profit may lead the auditor to conclude that materiality is more appropriately determined using a normalized profit before tax from continuing operations figure based on past results.~~
15. ~~A financial reporting period is normally a twelve-month period, but in some circumstances, such as for a new entity or a change in the financial reporting period, may be more or less than twelve months. In such circumstances, the auditor determines materiality in relation to the financial statements on which the auditor is reporting.~~
1416. ~~The auditor exercises professional judgment in determining a percentage to be applied to the chosen benchmark. There is a relationship between the percentage and the chosen benchmark, such that the percentage to be applied to profit before tax from continuing operations will normally be higher than the percentage to be applied to total revenue. For example, five percent of profit before tax from continuing operations is often used for a profit oriented entity in a manufacturing industry, while one percent of total revenue or total expenses is often used for a not-for-profit entity. A higher or lower percentage, however, may be deemed appropriate in the circumstances. Illustrative examples of percentages applied to benchmarks that might be considered include the following:~~
- ~~• For a profit oriented entity, five percent of profit before tax from continuing operations, or one half of one percent of total revenues.~~
 - ~~• For a not-for-profit entity, one half of one percent of total expenses or total revenues.~~

- ~~For an entity in the mutual fund industry, one half of one percent of net asset value.~~

~~The auditor may consider higher or lower percentages than those illustrated above to be appropriate.~~

- ~~15. When determining materiality, the auditor ordinarily considers prior periods' financial results and financial positions, the period-to-date financial results and financial position, and budgets or forecasts for the current period, taking account of significant changes in the entity's circumstances (e.g. a significant business acquisition) and relevant changes of conditions in the economy as a whole or the industry in which the entity operates. For example, when the auditor usually determines materiality for a particular entity based on a percentage of profit, circumstances that give rise to an exceptional decrease or increase in profit may lead the auditor to conclude that materiality is more appropriately determined using a normalized profit figure based on past results.~~
- ~~16. Materiality is determined without regard to the degree of inherent uncertainty associated with the measurement of particular items. For example, the fact that the financial statements include very large provisions with a high degree of estimation uncertainty (e.g., provisions 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) does not cause the auditor to determine the materiality level for the financial statements to be higher than for financial statements that do not include such inherent estimation uncertainties.~~

Materiality Levels for Particular ~~Items of Lesser Amounts than the Materiality Level Determined for the Financial Statements as a Whole~~ Classes of Transactions, Account Balances or Disclosures

17. When establishing the overall strategy for the audit, the auditor should **also** consider whether, in the specific circumstances of the entity, **there are particular classes of transactions, account balances or disclosures for which** 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 expected to influence **the economic decisions of users taken on the basis of the financial statements. In such circumstances, the auditor should determine the materiality levels to be applied to those particular classes of transactions, account balance or disclosures.** ~~Any such amounts determined represent lower materiality levels to be considered in relation to the particular items in the financial statements.~~
18. In making this judgment, the auditor ~~considers~~ **has regard to** factors such as the following:
- Whether ~~accounting standards,~~ law, ~~or~~ regulations **or the applicable financial reporting framework** affect users' expectations regarding the measurement or disclosure of certain items (e.g., related party transactions and the remuneration of management and those charged with governance).
 - The key disclosures in relation to the industry ~~and the environment~~ in which the entity operates (e.g., research and development costs for a pharmaceutical company).

- Whether attention is focused on the financial performance of a particular business segment that is separately disclosed in the financial statements (e.g., for a newly acquired business).
19. ~~In considering whether, in the specific circumstances of the entity, such classes of transactions, account balances or disclosures exist, the auditor may find it useful to obtain an understanding of the views and expectations of those charged with governance, and of management, may help the auditor judge whether, in the specific circumstances of the entity, misstatements of particular items of lesser amounts than the materiality level for the financial statements as a whole, if any, could reasonably be considered material by the users of the financial statements.~~

Tolerable Error⁴ Amount Lower than Materiality for Purposes of Assessing Risks and Designing Further Audit Procedures

20. ~~The auditor should determine one or more levels of tolerable error for classes of transactions, account balances and disclosures an amount lower than the materiality level for the financial statement as a whole (and an amount lower than the materiality level for a particular class of transactions, account balance or disclosure, if applicable) for purposes of assessing the risks of material misstatement and designing further audit procedures to respond to assessed risks.~~
21. ~~When assessing the risks of material misstatements and designing and performing further audit procedures to respond to the assessed risks, the auditor allows for the possibility that some misstatements of lesser amounts than the materiality levels determined in accordance with paragraphs 11 and 17 could, in the aggregate, result in a material misstatement of the financial statements. To do so, the auditor determines one or more levels of tolerable error. Such levels of tolerable error are lower than the materiality levels. It is not appropriate to plan the audit merely to detect material misstatements. To do so overlooks the fact that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated, and leaves no margin for possible undetected misstatements. The amount the auditor determines for purposes of assessing the risks of material misstatement and designing further audit procedures to respond to assessed risks is ordinarily set so that the probability is low that the total of detected and undetected misstatements in the financial statements exceeds materiality. The determination of this amount is not a simple mechanical calculation and requires the auditor to exercise professional judgment. It is affected by the auditor's knowledge of the entity, updated during the execution of the risk assessment procedures, and by the nature and extent of misstatements accumulated in previous audits (e.g., for an entity with a history of large or numerous misstatements accumulated in previous audits, the auditor determines the amount to be lower than if such misstatements were not present). In the case of audit sampling, this lower amount is the tolerable error referred to in ISA 530, "Audit Sampling and Other Means of Testing."~~

⁴ "Tolerable error" is the maximum error in a population (e.g., the class of transactions or account balance) that the auditor is willing to accept.

Considerations as the Audit Progresses

22. The auditor should revise the materiality levels for the financial statements as a whole (and the materiality level for a particular class of transactions, account balance or disclosure, if applicable) in the event of becoming aware of information during the audit that would have caused the auditor to have determined different materiality levels ~~to have been determined~~ initially.
23. ~~The auditor's determination of materiality for the financial statements as a whole and for particular items at the time of establishing the overall audit strategy may differ from that at the time of evaluating the results of further audit procedures. The materiality level for the financial statements as a whole (or the materiality level for a particular class of transactions, account balance or disclosure, if applicable) This may need to be revised because as a result of a change in circumstances that occurred during the audit, or because of new information, or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures. For example, the auditor may have based materiality on the anticipated period end financial results; if actual financial results are substantially different, the determination of materiality may also change.~~
24. If the auditor concludes that a lower materiality level than that initially determined is appropriate, the auditor reconsiders the related ~~levels of tolerable error amount determined for purposes of assessing risks of material misstatement and designing further audit procedures,~~ and the appropriateness of the nature, timing and extent of further audit procedures.

Communications with Those Charged with Governance

4425. Standards and guidance regarding communications about materiality to those charged with governance are set out in [proposed] ISA 260 (Revised), "Communication of Audit Matters with Those Charged with gGovernance."

Documentation

4526. The auditor should document:

- (a) ~~The levels of materiality~~ level for the financial statements as a whole;
- (b) The materiality level for a particular class of transactions, account balance or disclosure, if applicable ~~and;~~
- (c) ~~tolerable error, The amount (or amounts) determined for purposes of assessing risks of material misstatement and designing further audit procedures;~~
- (d) ~~including a~~ Any changes thereto, used in the audit made to (a)-(c) as the audit progressed; and
- (e) ~~the basis on which those levels~~ How the amounts in (a)-(d) were determined;

Effective Date

4727. This ISA is effective for audits of financial statements for periods beginning on or after [date].

Public Sector Perspective

1. In determining materiality for planning and performing the audit, the public sector auditor also considers legislative and regulatory requirements and the visibility and sensitivity of public sector programs that may affect that determination. A public sector auditor may also have additional responsibilities to report fraud, waste or abuse. This may require materiality levels different to those determined in accordance with the requirements and guidance of this ISA.
2. The financial statements of a public sector entity may be used to make decisions other than economic decisions. Furthermore, legislators and regulators are often the primary users of those financial statements. Consequently, their needs will meet most of the needs of other users of those financial statements, such as the public. In the audit of a public sector entity the collective needs of legislators or regulators as a group, therefore, may be an appropriate frame of reference when determining materiality.
3. In an audit of a public sector entity, total cost or net cost (expenses less revenues or expenditure less receipts) may be appropriate benchmarks for program activities. Where a public sector entity has custody of public assets, assets may be an appropriate benchmark.