

MARK-UP BASED ON DECEMBER 2006 “CLOSE OFF” DRAFT
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 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~~ during the audit of financial statements is addressed in ISA ~~XXX~~ 450, “Evaluation of Misstatements Identified During the Audit.”
2. **The auditor should ~~consider~~ determine an appropriate materiality level or levels ~~when planning and performing to enable 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~~.**
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. Materiality and audit risk are considered throughout the audit, in particular, when:
 - (a) 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) Determining the nature, timing and extent of further audit procedures (see ISA 330, “The Auditor’s Procedures in Response to Assessed Risks”); and
 - (c) Evaluating the effect of uncorrected misstatements¹ on the financial statements and the related auditor’s report (see ISA ~~XXX~~ 450).

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 statements. The auditor therefore plans and performs the audit to obtain reasonable assurance that material misstatements are detected.~~
4. Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:
 - ~~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~~

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

~~misstatements, including omissions, which could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;~~

- ~~Judgments about materiality are made in the light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and~~
- ~~Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.²~~

5. ~~Such a discussion, if present in the applicable financial reporting framework, provides a frame of reference to the auditor in determining a materiality level or levels for the audit. If the applicable financial reporting framework does not include a discussion of materiality, the elements referred to in paragraph 4 provide the auditor with such a frame of reference.~~

6. ~~The auditor's determination of a materiality level or levels 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. 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. ~~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~~

² ~~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.~~

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.~~

When determining materiality in audits of financial statements prepared for a special purpose, the auditor considers the needs of specific users in the context of the objective of the engagement.

- ~~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.~~
- ~~8. If the applicable financial reporting framework contains a definition of materiality, 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 paragraphs 5-6 and, accordingly, the auditor's judgment as to what would be material in the circumstances is not expected to vary significantly.~~
7. The auditor uses the concept of materiality both in planning and performing the audit, and in evaluating the effect of identified misstatements on the financial statements and the related auditor's report.
8. In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. These judgments affect the nature, timing and extent of audit procedures. The materiality level or levels determined when planning the audit do not necessarily establish a threshold below which misstatements identified during the audit will always be evaluated as immaterial. The circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are below the materiality level or levels. As discussed in [proposed] ISA 450, the auditor considers not only the size but also the nature of any identified misstatements, and the particular circumstances of their occurrence, when evaluating their effect on the financial statements and the auditor's report. However, when performing the audit, although the auditor is alert for misstatements that could be material because of their nature, it is not practicable to design audit procedures to detect such misstatements.

Determining Materiality when Planning the Audit

Materiality Level for the Financial Statements as a Whole

- 9. When establishing the overall audit strategy, the auditor should determine a materiality level for the financial statements as a whole for purposes of:**
 - (a) Determining the nature, timing and extent 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.**
- ~~10. This materiality level does not establish a threshold below which 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 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 Benchmarks in Determining Materiality

~~1110.~~ Determining what is material to users of the financial statements a materiality level for the financial statements as a whole requires the exercise of professional judgment. The auditor often applies a percentage to a chosen benchmark as a starting point in ~~determining a materiality level for the financial statements as a whole~~ that determination.

~~1211.~~ 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, expenses);
- Whether there are items on which the attention of the users of the particular entity's financial statements 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 the entity operates;
- The ~~size of the entity, nature of its~~ entity's ownership structure 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.

~~1312.~~ Examples of benchmarks that may be appropriate, depending on the circumstances of the entity, include categories of reported income such as profit before tax, total revenue, gross profit and total expenses, total equity or net asset value. Profit before tax from continuing operations is often used for profit-oriented entities. 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 profit before tax in the form of remuneration, a benchmark such as profit before remuneration and tax may be more relevant.

~~1413.~~ Having identified an appropriate benchmark, the auditor identifies relevant financial data to be used in determining the materiality level for the financial statements as a whole. 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 the materiality level 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 the materiality level is more appropriately determined using a normalized profit before tax from continuing operations figure based on past results.

~~1514.~~ A The auditor determines the materiality level in relation to the financial statements on which the auditor is reporting. Where the financial statements are prepared for a financial reporting period ~~is normally a twelve-month period, but in some circumstances of more or less than twelve months,~~ such as may be the case 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 the materiality level in relation to the financial statements ~~on which the auditor is prepared for that financial~~ reporting period.

~~1615.~~ 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, the auditor may consider five percent of profit before tax from continuing operations ~~is often used to be appropriate~~ for a profit oriented entity in a manufacturing industry, while the auditor may consider one percent of total revenue or total expenses ~~is often used to be appropriate~~ for a not-for-profit entity. A higher or lower percentage, however, may be deemed appropriate in the circumstances.

Materiality Levels for Particular Classes of Transactions, Account Balances or Disclosures

~~1716.~~ **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 lesser amounts than the materiality level for the financial statements as a whole could 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 balances or disclosures.**

~~1817.~~ In making this judgment, the auditor has regard to factors such as the following:

- Whether law, 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 in which the entity operates (e.g., research and development costs for a pharmaceutical company).
- Whether attention is focused on a particular aspect of the ~~financial performance of a particular entity's~~ business ~~segment~~ that is separately disclosed in the financial statements (e.g., ~~for~~ a newly acquired business).

~~1918.~~ 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 management.

Amounts Lower than the Materiality Level or Levels for Purposes of Assessing Risks and Designing Further Audit Procedures

2019. To reduce the risk that the aggregate of detected and undetected misstatements in the financial statements exceeds the materiality level or levels determined for the audit, ~~the~~ the auditor should determine an amount lower than the materiality level for the financial statements as a whole (~~and~~ or an amount or amounts lower than the materiality level for a particular classes of transactions, account balances or disclosures, if applicable) for purposes of assessing the risks of material misstatement and designing further audit procedures to respond to assessed risks.

2120. ~~It is not appropriate to plan Planning~~ the audit ~~merely solely~~ to detect individually 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 or amounts 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~~ to reduce to an appropriately low level the probability ~~is low~~ that the total of detected and undetected misstatements in the financial statements exceeds the materiality level or levels. The determination of this amount or amounts 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 or amounts 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."~~

Considerations as the Audit Progresses

2221. The auditor should revise the materiality level 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 initially.

2322. 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) may need to be revised as a result of a change in circumstances that occurred during the audit, 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 during the audit the auditor becomes aware that actual financial results are likely to be substantially different, from the anticipated period end financial results that were used to determine the materiality level or levels, the auditor may need to revise the materiality ~~may also change~~ level or levels.

2423. If the auditor concludes that ~~a~~ lower materiality level or levels than that initially determined is are appropriate, the auditor reconsiders the ~~related~~ lower amount or amounts 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

~~2524. Standards and guidance regarding communications about materiality to those charged with governance are set out in [proposed] ISA 260 (Revised), “Communication with Those Charged with Governance.”~~[Proposed] ISA 260 (Revised), “Communication with Those Charged with Governance” establishes standards and provides guidance on communications about materiality with those charged with governance.

Documentation

~~2625.~~ **The auditor should document:**

- (a) **The materiality level for the financial statements as a whole** (see paragraph 9);
- (b) **The materiality level for a particular class of transactions, account balance or disclosure, if applicable** (see paragraph 16);
- (c) **The amount (or amounts) determined for purposes of assessing risks of material misstatement and designing further audit procedures** (see paragraph 19);
- (d) **Any changes made to (a)-(c) as the audit progressed** (see paragraphs 21 and 23); and
- (e) **How the amounts in (a)-(d) were determined.**

Effective Date

~~2726.~~ This ISA is effective for audits of financial statements for periods beginning on or after [date].

Public Sector Perspective

1. 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.

2. In determining The determination of materiality level or levels for planning and performing the in an audit of a public sector entity, the public sector auditor also considers is influenced by legislative and regulatory requirements, and by public expectations around 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.*

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