

**PROPOSED INTERNATIONAL STANDARD ON AUDITING 320
(REVISED AND REDRAFTED)****MATERIALITY IN PLANNING AND PERFORMING AN AUDIT**

(Effective for audits of financial statements for periods beginning on or after December 15, 2009)

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International Standard on Auditing (ISA) 320 (Revised and Redrafted), “Materiality in Planning and Performing an Audit” should be read in the context of [proposed] ISA 200 (Revised and Redrafted), “Overall Objective of the Independent Auditor, and the Conduct of an Audit in Accordance with International Standards on Auditing,” which sets out the authority of ISAs. **[ISSUE H]**

Introduction

Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibility to apply materiality in planning and performing an audit of financial statements. ISA 450 (Revised and Redrafted)¹ explains how materiality is applied in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements.

Materiality in the Context of an Audit

2. 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:
 - 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 light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both;
 - 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.² The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered; and (Ref: Para. A1)
 - Judgments about materiality are made in relation to the relevant financial reporting period.
3. Such a discussion, if present in the applicable financial reporting framework, provides a frame of reference to the auditor in determining materiality for the audit. If the applicable financial reporting framework does not include a discussion of materiality, the characteristics referred to in paragraph 2 provide the auditor with such a frame of reference.
4. The auditor's determination 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. In this context, this ISA is written on the basis 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;

¹ ISA 450 (Revised and Redrafted), "Evaluation of Misstatements Identified during the Audit."

² For example, the "Framework for the Preparation and Presentation of Financial Statements," adopted by the International Accounting Standards Board in April 2001, 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.

- (b) Understand that financial statements are prepared, presented 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.
5. The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and the opinion in the auditor's report. (Ref: Para. A2)
6. In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. These judgments provide a basis for:
- (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.

The materiality determined when planning the audit does not necessarily establish an amount below which uncorrected misstatements, individually or in the aggregate, 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 materiality. Although it is not practicable to design audit procedures to detect misstatements that could be material solely because of their nature, the auditor considers not only the size but also the nature of uncorrected misstatements, and the particular circumstances of their occurrence, when evaluating their effect on the financial statements³ and the opinion in the auditor's report. [ISSUE I] [ISSUE J.1]

Effective Date

7. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2009.

Objective

8. The objective of the auditor is to apply materiality appropriately in planning and performing the audit. [ISSUE A]

Definition

9. For purposes of the ISAs, the following terms have the meaning attributed below:
- (a) Materiality – The materiality level for the financial statements as a whole. [ISSUE B.1]

³ ISA 450 (Revised and Redrafted), paragraph A15.

- (b) Operational materiality – An amount set by the auditor at less than materiality to reduce to an appropriately low level the probability that the total of uncorrected and undetected misstatements exceeds materiality. [ISSUE B.2]

Requirements

Determining Materiality when Planning the Audit

- 10. When establishing the overall audit strategy, the auditor shall determine materiality. (Ref: Para. A3-A10)

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

- 11. The auditor shall also determine 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 materiality could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. In such circumstances, the auditor shall determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures. The requirements in paragraphs 12-14 shall also apply to the materiality level or levels determined in accordance with this paragraph. (Ref: Para. A11-A12) [ISSUE B.1]

Operational Materiality

- 12. The auditor shall determine operational materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures. (Ref: Para. A13) [ISSUE B.2] [ISSUE I]

Revision as the Audit Progresses

- 13. The auditor shall revise materiality in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different materiality initially. (Ref: Para. A14)
- 14. If the auditor concludes that a lower materiality than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise operational materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate.

Documentation

- 15. The auditor shall document the following amounts and the factors considered in their determination:
 - (a) Materiality (see paragraph 10);
 - (b) The materiality level for a particular class of transactions, account balance or disclosure, if applicable (see paragraph 11);
 - (c) Operational materiality (see paragraph 12); and
 - (d) Any revision of (a)-(c) as the audit progressed (see paragraphs 13-14).

* * *

Application and Other Explanatory Material

Materiality in the Context of an Audit (Ref: Para. 2)

Considerations Specific to Public Sector Entities

A1. In the case of a public sector entity, legislators and regulators are often the primary users of its financial statements. Furthermore, the financial statements may be used to make decisions other than economic decisions.

Materiality and Audit Risk (Ref: Para.5)

A2. The overall objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and to report in accordance with the auditor's findings.⁴ The auditor obtains reasonable assurance by reducing audit risk to an acceptably low level, through accumulating and evaluating sufficient appropriate audit evidence. 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;⁵
- (b) Determining the nature, timing and extent of further audit procedures;⁶ and
- (c) Evaluating the effect of uncorrected misstatements, if any, on the financial statements and the opinion in the auditor's report.⁷

Determining Materiality when Planning the Audit

Considerations Specific to Public Sector Entities (Ref: Para.10)

A3. The determination of materiality in an audit of the financial statements of a public sector entity is influenced by legislative and regulatory requirements, and by the financial information needs of legislators and the public in relation to public sector programs.

⁴ [Proposed] ISA 200 (Revised and Redrafted), "ISA 200 (Revised and Redrafted), "Overall Objective of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing," paragraph [12].

⁵ ISA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatements Through Understanding the Entity and Its Environment."

⁶ ISA 330 (Redrafted), "The Auditor's Responses to Assessed Risks."

⁷ ISA 450 (Revised and Redrafted).

Use of Benchmarks in Determining Materiality (Ref: Para. 10) [ISSUE I]

- A4. Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in that determination. Factors that may affect the identification of an appropriate benchmark include the following:
- The elements of the financial statements (for example, 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 (for example, 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 in its life cycle, and the industry and economic environment in which the entity operates;
 - The entity's ownership structure and the way it is financed (for example, 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.
- A5. 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.
- A6. In relation to the chosen benchmark, relevant financial data ordinarily includes prior periods' financial results and financial positions, the period-to-date financial results and financial position, and budgets or forecasts for the current period, adjusted for significant changes in the circumstances of the entity (for example, a significant business acquisition) and relevant changes of conditions in the industry or economic environment in which the entity operates. For example, when, as a starting point, materiality is determined 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.
- A7. Materiality relates to the financial statements on which the auditor is reporting. Where the financial statements are prepared for a financial reporting period 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, materiality relates to the financial statements prepared for that financial reporting period.
- A8. Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment. There is a relationship between the percentage and the chosen benchmark, such that a percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue. For example, the auditor may consider five percent of profit before tax from continuing operations 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 to be appropriate for a not-for-profit entity. Higher or lower percentages, however, may be deemed appropriate in the circumstances.

Considerations Specific to Small Entities

A9. 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.

Considerations Specific to Public Sector Entities

A10. 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.

Materiality Levels for Particular Classes of Transactions, Account Balances or Disclosures (Ref: Para. 11)

A11. Factors that may affect the auditor's consideration of whether to determine lower materiality level or levels to be applied to particular classes of transactions, account balances or disclosures include the following:

- Whether law, regulations or the applicable financial reporting framework affect users' expectations regarding the measurement or disclosure of certain items (for example, 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 (for example, research and development costs for a pharmaceutical company).
- Whether attention is focused on a particular aspect of the entity's business that is separately disclosed in the financial statements (for example, a newly acquired business).

A12. 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.

Operational Materiality (Ref: Para. 12)

A13. Planning the audit solely to detect individually material misstatements 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. Operational materiality is set to reduce to an appropriately low level the probability that the total of uncorrected and undetected misstatements in the financial statements exceeds materiality. The determination of operational materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by the auditor's understanding of the entity, updated during the performance of the risk assessment procedures, and by the nature and extent of misstatements accumulated in previous audits (for example, for an entity with a history of large or numerous misstatements accumulated in previous audits, operational materiality would be lower than if such misstatements were not present).

Revision as the Audit Progresses (Ref: Para. 13)

A14. Materiality may need to be revised as a result of a change in circumstances that occurred during the audit (for example, a decision to dispose of a major part of the entity's business), 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, if during the audit it appears as though actual financial results are likely to be substantially different from the anticipated period end financial results that were used initially to determine materiality, the auditor revises materiality.