Improving Compliance with International Standards on Auditing

ISA 320 Materiality in Planning and Performing an Audit

Introduction and Overview

- Aim of this session
  - Considerations
  - Requirements
  - Your role
  - General discussion

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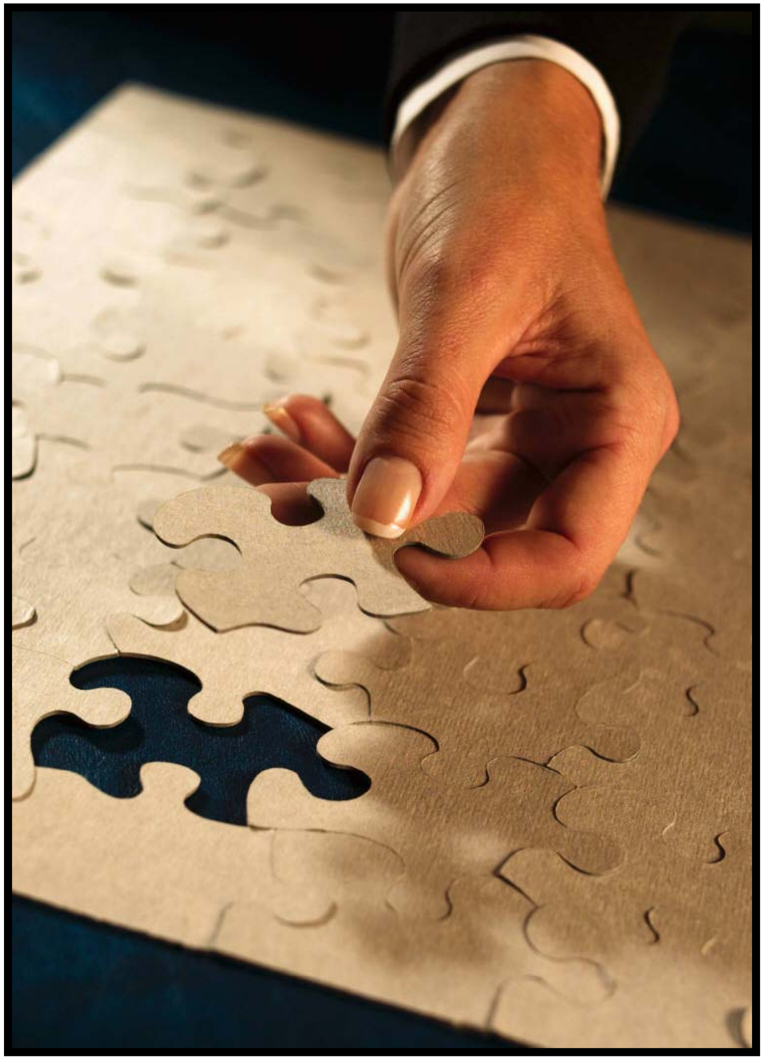

ISA 320 Considerations

Recent observations

- **Concept** of materiality
- How to determine materiality when **auditing an account**
- **Performance materiality**
- **Calculation** of overall and performance materiality

Why is materiality important?

What impact does materiality have on the audit engagement?

What is materiality?

- The concept of materiality is considered throughout the audit, in particular, when:
  - Identifying and assessing the risks of material misstatement;
  - Determining the nature, timing and extent of further audit procedures; and
  - Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report (ISA 320.A1).
- The auditor's assessment of materiality helps the auditor determine the amount of work necessary to reduce audit risk to an acceptably low level.

Scope

- **ISA 320** deals with the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements.

- **ISA 450** 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

- 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;

Materiality in the Context of an Audit

- 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; and

Materiality in the Context of an Audit

- 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.

IFRS Framework

- The relevance of information is affected by its **nature** and **materiality**.
- Information is **material** if its omission or misstatement could 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.

Determination of Materiality

- Matter of **professional judgment.**
  Determination should involve engagement leader.

- Affected by the auditor's perception of the financial **information needs of users** of the financial statements.

Reasonable assumptions

- Users 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;
- Understand that financial statements are prepared, presented and **audited to levels of materiality**;
- Recognize the **uncertainties inherent** in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and
- **Make reasonable economic decisions** on the basis of the information in the financial statements.

Applying Materiality

The concept of materiality is applied

- 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 in **forming the opinion** in the auditor's report.

Applying Materiality

- In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material.
- These judgments provide a basis for:
  - Determining the nature, timing and extent of **risk assessment procedures**;
  - Identifying and assessing the **risks of material misstatement**; and
  - Determining the nature, timing and extent of **further audit procedures**.

Applying Materiality

- 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 statements.

Materiality and Audit Risk

In conducting an audit of financial statements, 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 on the financial statements, and communicate as required by the ISAs, in accordance with the auditor's findings.

Materiality and Audit Risk

- The auditor obtains **reasonable assurance** by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level.
- 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 **risks of material misstatement** and **detection risk**.

Materiality and Audit Risk

- Materiality and audit risk are **considered throughout the audit**, in particular, when:
  - Identifying and assessing the **risks of material misstatement**;
  - Determining the **nature, timing and extent** of further audit procedures; and
  - **Evaluating the effect of uncorrected misstatements**, if any, on the financial statements and in forming the opinion in the auditor's report.

ISA 320 Requirements

Objective

Auditor's objective is to apply the concept of materiality appropriately in **planning** and **performing** the audit.

Requirements

- Determine materiality for the FS **as a whole**.
- Determine materiality level(s) to be applied to **particular classes of transactions, account balances or disclosures** for which misstatements of lesser amounts could reasonably be expected to influence economic decisions of users.
- Determine **performance materiality** for purposes of
  - Assessing the risks of material misstatement and
  - Determining the nature, timing and extent of further audit procedures.

Use of Benchmarks

- A percentage is often applied to a chosen benchmark as a starting point.
- Factors that may affect identification of appropriate benchmark:
  - The elements of the financial statements;
  - Items on which attention of the particular users of the entity's financial statements tends to be focused;
  - 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; and
  - The relative volatility of the benchmark.

Examples of Benchmarks

- Categories of reported income, eg PBT
- Total revenue
- Gross profit and
- Total expenses
- Total equity
- Net asset value

Examples of Benchmarks

- 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.
- Circumstances giving rise to exceptional decrease/increase in profit may indicate that materiality may be more appropriately determined using a normalized PBT from continuing operations.

Percentage of Benchmark

- 5% of income from continuing operations (normalized)
- ½ to 2% of revenues/expenses (not-for-profit)
- ½ to 1% of net asset value for the mutual funds, etc
- 1% of revenue for real estate industry

Suggestions only!

Determining a percentage to be applied to a chosen benchmark involves the exercise of **professional judgment**!

Reporting Period

- Materiality relates to financial statements on which auditor is reporting.

- Where financial statements prepared for financial reporting period of more/less than twelve months, materiality relates to the financial statements prepared for that financial reporting period.

Performance Materiality

- Amount or amounts set at less than overall materiality …

  to reduce to an appropriately low level …

  the probability that the aggregate of uncorrected and undetected misstatements …

  exceeds materiality for the financial statements as a whole or…

  for particular classes of transactions, account balances or disclosures.

Performance Materiality

- Aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated

- Not a simple mechanical calculation; involves the exercise of professional judgment.

Performance Materiality

- Affected by
  - The auditor's **understanding of the entity**, updated during the performance of the risk assessment procedures; and
  - The nature and extent of misstatements identified in previous audits and thereby the **auditor's expectations** in relation to misstatements in the current period.

Specific Materiality

When would we need to determine materiality for particular classes of transactions, account balances or disclosures?

Levels of Materiality

Overall materiality	Assessment of materiality at the financial statement level
Performance materiality	Materiality at assertion level in relation to classes of transactions, account balances and disclosures
Materiality for particular classes of transactions, account balances and disclosures	Materiality for particular items of lesser amounts than overall materiality
De minimis	Amount below which adjustments are unlikely to impact financial statements

Reassessing Materiality

Reassessing materiality

- There may be some circumstances when we need to reassess materiality during the audit:
  - A significant change in circumstances
  - A change in our understanding of the entity and its operations as a result of performing further audit procedures
  - The number and type of audit adjustments identified as a result of audit procedures, whether they are correct or uncorrected

Reassessing materiality

ISA 320 requires:

- Revision of materiality for information that would have caused us to have determined a different amount initially
- If we determine that lower materiality is appropriate, determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate

Consider materiality as a whole and, if applicable, for particular classes of transactions, account balances or disclosures.

Documentation

Documentation

- The auditor shall include in the audit documentation the following amounts and the factors considered in their determination:
  - Materiality for the financial statements **as a whole**
  - If applicable, the materiality level or levels for **particular classes of transactions, account balances or disclosures**
  - **Performance materiality**; and
  - Any **revision** of the above as the audit progressed

(ISA 320.14)

Your Role

What is your role with regards to materiality on an audit engagement?

Conclusion

Summary

- Materiality should be considered throughout the audit process
- Assessment of materiality helps to determine amount of work necessary to reduce audit risk to acceptable level
- Assessment of materiality requires professional judgement
- Assessment of materiality requires engagement leader involvement

Summary

- To determine materiality, we identify a relevant benchmark to which we apply an appropriate percentage
- We may need to determine additional specific materiality levels
- Be alert to circumstances when we may need to reassess materiality during the audit
- If reevaluated, document rationale and consider impact on performed and to be performed

General Discussion

Questions???

Thank you!