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# Agenda Item 10

**Committee:** IAASB

**Meeting Location:** New York

**Meeting Date:** July 21-25, 2003

## Materiality

### Objectives of Agenda Item

To review and discuss the first draft of the proposed exposure draft of a revised ISA 320, "Audit Materiality."

### Background

ISA 320 was first issued in 1987 and was revised as part of the codification in 1994. The Standard was subsequently examined in 1995 and no fatal flaws were identified. The recommendations of the Big Five Materiality Task Force in 1998 have, however, been influential on subsequent guidance issued by national auditing standard setters (notably Australia, Canada and the US), particularly regarding qualitative considerations.

At its June 2002 meeting the IAASB approved a review of ISA 320 by a Task Force chaired by Graham Ward. The Task Force comprises members of both IAASB and the Auditing Practices Board of the United Kingdom and Ireland.

The primary issues identified by the Task Force that have led to the most substantive proposed changes to the extant ISA 320 are:

- The definition of materiality, giving recognition to the nature as well as the size of items, and maintaining consistency with definitions in International Accounting Standards.
- The need for a more holistic approach to determining materiality, with greater consideration at the planning stage of the nature of items, as well as their size, and the circumstances of the entity; and consideration of the use of different levels of materiality for planning the audit of different elements of the financial statements reflecting the perceived significance to users.
- The need for additional guidance on the factors that affect audit materiality.
- The need for additional guidance on the auditor's reporting responsibilities, including communication with management and those charged with governance.
- The encouragement of management to correct all identified misstatements, including those that are immaterial.

These issues were considered by IAASB at its December 2002 meeting and agreed as appropriate for the Task Force to focus on. The Task Force proceeded with the development of a draft exposure draft on that basis.

## Particular Matters for the Attention of IAASB

The Task Force draws the following particular matters to the attention of IAASB for consideration when reviewing the draft exposure draft.

### THE TITLE OF THE DRAFT EXPOSURE DRAFT

The Task Force believes that it is inappropriate for the title of the draft exposure draft to focus on audit materiality. Ideally the auditor and the preparer of the financial statements should share the same views as to what is material to a user of the audited financial statements. Also, it was not felt to adequately reflect the increased guidance in the draft exposure draft on the identification and evaluation of misstatements. Therefore, the Task Force has adopted the proposed title "Materiality in the Identification and Evaluation of Misstatements".

### THE DEFINITION OF MATERIALITY AND GUIDANCE ON USERS

The Task Force presented an issues paper on the definition of materiality and related guidance on users at the May 2003 IAASB meeting (Agenda Paper 4-A for that meeting). Following discussion of that paper, it was suggested that the Task Force should consider:

- IAASB's concern that the description of users might be too specific.
- The implications of determining materiality levels based on the needs of users (including the needs of users the auditor might not be familiar with).
- The reference to "investors" in paragraph 10 of the International Accounting Standards Board's "Framework for the Preparation and Presentation of Financial Statements" (the IASB Framework).
- How the concept of "duty of care" has been handled in footnote 10 of the proposed "International Framework for Assurance Engagements" (the proposed Framework).

The Task Force believes that it is appropriate to define materiality with reference to users. This is consistent with the extant ISA 320, a number of national auditing standards and with standards issued by the IASB. The Task Force continues to believe that if users are referred to in the definition, the proposed revised ISA should provide guidance on the auditor's consideration of who are the users of financial statements and the level of financial knowledge it would be reasonable to assume they have (e.g. to make clear that the term "users" in the definition of materiality does not include all potential users of the audited financial statements).

In response to the suggestions made at the May 2003 IAASB meeting, the Task Force has made the following changes in the draft exposure draft:

(*a*) The second bullet point in paragraph 4 been amended to refer to "Other users to whom the auditor has a known duty of care." A new sentence has been added to the related footnote (1) stating that "The absence of a restriction regarding a particular user or class of user does not indicate that a duty of care is owed by the auditor to that user or class of user." The new sentence is based on footnote 10[1] to the proposed Framework.

These changes are intended to avoid the proposed ISA requiring auditors to have regard to the needs of users for whom they may not be aware that they have a duty of care; and also to be more consistent with the approach to the duty of care taken in the proposed Framework.

(*b*) A sub paragraph has been added to paragraph 4, stating that "As investors are providers of risk capital, consideration of their perceived needs will also meet most of the needs of other users of the financial statements." This is based on paragraph 10[2] of the IASB Framework.

THE CLASSIFICATION OF MISSTATEMENTS

In paragraph 13 of the draft exposure draft, misstatements are classified for audit purposes as:

(*a*) Known misstatements

These are specific misstatements identified during the audit including, for example, those arising from mistakes in gathering or processing data, the wrong application of accounting principles and, in the context of accounting estimates, the oversight of facts or use of inappropriate assumptions. Their existence is not in doubt.

(*b*) Likely misstatements

These are misstatements estimated by the auditor that most likely exist based on audit evidence obtained. For example the projected effect of known misstatements identified in audit samples.

(*c*) Differences in judgment

These are differences between management's and the auditor's judgments concerning accounting estimates or the application of accounting principles.

The classifications of "known" and "likely" misstatements are in common use. The separate classification of "differences in judgment" is not, as far as the Task Force is aware, currently in common use. It has been introduced because the Task Force believes it to be a significant, separate, category of misstatements and distinguishing it will lead to clearer thinking by auditors when evaluating the effects of identified misstatements on the financial statements and discussing them with those charged with governance.

MULTIPLE LEVELS OF MATERIALITY

The extant ISA 320 supports an audit approach that may result in different materiality levels being used in one audit.[3] The Task Force believes that the current approach to materiality adopted

1 Footnote 10 to the proposed Framework states "While an assurance report may be restricted whenever it is intended only for specified intended users or for a specific purpose, the absence of a restriction regarding a particular reader or purpose, does not indicate that a duty of care is owed by the practitioner in relation to that reader or for that purpose."

2 Paragraph 10 of the IASB Framework states "While all of the information needs of these users cannot be met by financial statements, there are needs which are common to all users. 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 ISA 320 (paragraph 7) states "The auditor considers materiality at both the overall financial statement level and in relation to individual account balances, classes of transactions and disclosures. Materiality may be influenced by considerations such as legal and regulatory requirements and considerations relating to

by auditors tends to involve a strong focus on a single benchmark/threshold amount for planning materiality and overall evaluation of the financial statements. The importance of qualitative factors is acknowledged but they tend to be considered primarily at the stage of evaluating misstatements rather than at the planning stage and the design of audit procedures. Also, there is often significantly more weight given to the effect of misstatements on the profit or loss of the entity other than on elements of the financial statements which, for some users, may be at least as important.

The Task Force believes that it is important that materiality levels should be determined at the planning stage that take into account the different sensitivities of users of audited financial statements to different items in those financial statements (i.e. to recognize that misstatements of different amounts may be material in relation to different classes of transaction, account balances and disclosures). For example, users may be more sensitive to misstatements in particular financial indicators (e.g. items that affect the solvency ratio of an insurance company) or misstatements that affect loan covenants (e.g. a requirement to maintain specified interest multiples). Paragraph 16 of the draft exposure draft states that:

> "… users of the audited financial statements may be more sensitive to misstatements in relation to certain classes of transactions, account balances and disclosures than in relation to others, and to the trends and ratios that may be derived from them. Accordingly, when determining materiality levels and assessing the risks of material misstatement, in addition to considering materiality at the overall financial statement level, the auditor considers whether there are particular classes of transactions, account balances and disclosures for which different levels of materiality are appropriate for use in planning, and evaluating, audit procedures. This results typically in more than one level of materiality being established (although it is not, ordinarily, necessary to separately determine individual materiality levels for every item in the financial statements)."

The Task Force is aware that some auditors may be concerned that they need to identify separate materiality levels for every separate item in the financial statements. This should not, ordinarily, be the case and the wording in brackets at the end of paragraph 16 is intended to emphasize that.

The draft exposure draft also recognizes that misstatements generally affect more than one account balance. Paragraph 17 states:

> "The materiality level for a particular class of transaction, account balance or disclosure cannot be greater than materiality at the overall financial statement level. Where two or more classes of transaction or account balance are related such that a misstatement of one is matched by misstatement of the other(s), the auditor determines materiality for each of those classes of transaction or account balance at the lowest level appropriate to any one of them."

Paragraphs 18 to 21 of the draft exposure draft provide further guidance in relation to matters the auditor considers when considering the importance to users of different items in the financial statements and when selecting benchmarks on which to base initial evaluations of materiality.

### ALLOCATION OF MATERIALITY

The Task Force considered whether the draft exposure draft should address the concept of the "allocation of materiality" (e.g. to different account balances, in proportion to their relative sizes) for the purpose of planning audit procedures. This is an approach that is used by some, but not all, audit firms. It provides a means of apportioning work effort rather than determining that lower

individual financial account statement account balances and relationships. This process may result in different materiality levels depending on the aspect of the financial statements being considered."

levels of materiality apply to smaller account balances. The Task Force concluded that the draft exposure draft should not address this concept.

The determination of different levels of materiality to take account of the different sensitivities of users of audited financial statements to different items in those financial statements (see section above) is not the same process as allocating materiality (the aim of the draft exposure draft is for the auditor to identify specific levels of materiality applicable to the consideration of different elements of the financial statements, not to apportion work effort), but may, nonetheless, provide results that assist in the apportionment of work effort.

The Task Force considers that if specific guidance on how to apportion work effort is considered necessary by IAASB, it would be more appropriately addressed in ISAs that relate to obtaining audit evidence (such as ISA 530 and/or the proposed new ISA on 'The Auditor's Procedures in Response to Assessed Risks').

As previously agreed by IAASB, guidance on materiality in relation to the audit of group financial statements and the levels to use for components is being considered by the Group Audits Task Force.

### COMMUNICATION OF MISSTATEMENTS

Paragraphs 28-38 of the exposure draft address the documentation and communication of misstatements to management and those charged with governance. They incorporate standards and guidance based on paragraphs that the Fraud Task Force has identified need to be repositioned other than in ISA 240 (as the proposed revision to ISA 240 addresses only matters relating to fraud and not error).

The Task Force believes that much of this section could be addressed in ISA 260, "Communication of Audit Matters with Those Charged with Governance" and ISA 580, "Management Representations". As the revision of those ISAs is at a relatively early stage, however, the Task Force has concluded that it is appropriate to include the standards and guidance in a revised ISA 320.

### "TOLERABLE ERROR" AND MATERIALITY OF "OTHER INFORMATION"

The Task Force has considered whether the draft exposure draft should address the topics of "tolerable error"[4] and the materiality of "other information" included in documents containing audited financial statements. The Task Force has concluded that it should not. These topics, as at present, are more appropriately addressed in ISA 530 "Audit Sampling and Other Selective Testing Procedures" and ISA 720 "Other Information in Documents Containing Audited Financial Statements."

However, the Task force believes that the relevant standards and guidance in ISAs 530 and 720 need to be revised and has given a written recommendation to that effect, and explained the rationale, to the Chairman of IAASB. [See copy of letter - Agenda Paper 10-B.]

4 Tolerable error is defined in the IAASB's Glossary of Terms and in ISA 530 as "the maximum error in a population that the auditor is willing to accept." ISA 530 also states (in paragraph 51) that "For substantive procedures, tolerable error is the tolerable misstatement, and will be an amount less than or equal to the auditor's preliminary estimate of materiality used for the individual account balances being audited."

THE TERMS "MANAGEMENT" AND "THOSE CHARGED WITH GOVERNANCE"

The IAASB's Glossary of Terms defines these as follows:

> *Management* - Management comprises officers and others who also perform senior managerial functions. Management includes directors and the audit committee only in those instances when they perform such functions.
>
> *Governance* - The term "governance" describes the role of persons entrusted with the supervision, control and direction of an entity. Those charged with governance ordinarily are accountable for ensuring that the entity achieves its objectives, financial reporting, and reporting to interested parties. Those charged with governance include management only when it performs such functions.

The term "those charged with governance" is a relatively new addition to the Glossary and to ISAs. The split of responsibilities between management and those charged with governance is not always clear and is exacerbated by structures of governance varying from country to country and within different types of entity (e.g. in smaller entities, management and those charged with governance are often the same individuals). This is recognized in ISA 260, "Communications of Audit Matters to Those Charged With Governance" which includes several paragraphs of guidance in relation to determining those persons who are charged with governance. The guidance in ISA 260 is not, however, included in the Glossary or in other ISAs which are now incorporating the term.

A particular issue that the Task Force has encountered is how to refer to those individuals in an entity who are responsible for approving and issuing the financial statements. This has led to the inclusion in its draft exposure draft of the term "those who are responsible for approving and issuing the financial statements" (in paragraphs 9, 37 and 38).

Given the increasing importance that is likely to attach to the distinction between the responsibilities of management and those charged with governance, the Task Force believes that IAASB needs to clarify the definitions.

**Material Presented**

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| Agenda Paper 10-A<br>(Pages 1011–1024) | Draft exposure draft |
| Agenda Paper 10-B<br>(Pages 1025–1028) | Copy of letter sent by the Task Force to the Chairman of IAASB |

**Action Requested**

IAASB is asked to review the draft exposure draft and provide the Task Force with feedback to enable it to prepare a revised draft exposure draft for approval for issue.