

Revision of ISA 320 “Audit Materiality” – Issues Paper**Issues Identified by the Task Force**

1. The following issues have been identified by the Materiality Task Force for consideration by the IAASB.
 - Scope of the proposed revised ISA
 - Development of a more holistic approach to the consideration of qualitative factors at the planning stage
 - The definition of materiality
 - Overlap with other ISAs
 - Unadjusted misstatements from prior periods
 - Correction of immaterial misstatements
 - Consideration of “other” information
 - Working with the International Accounting Standards Board (IASB)
 - Who are the “users” of financial statements and auditor’s reports
 - Small audits
 - Guidance for users of audited financial information

Scope of the Proposed Revised ISA

2. 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. However, the recommendations of the Big Five Materiality Task Force in 1998 have been influential on subsequent guidance issued by national auditing standard setters (notably Australia, Canada and the US), particularly regarding qualitative considerations.
3. At the end of 2001, IAPC staff compared ISA 320 with Australian, Canadian, South African and US guidance regarding audit materiality, and also considered the recommendations of the Big Five Audit Materiality Task Force. A summary was prepared for the IAPC Revisions Subcommittee setting out IAPC staff recommendations for proposed revisions.
4. The Task Force has considered the proposed revisions suggested by the IAPC staff. It has also itself reviewed the revised national auditing standards and guidance to identify any further potential revisions, and has considered whether there are any other topics that should be addressed that are not currently covered by any of the standards. The attachment to this paper lists the potential revisions and identifies whether or not the Task Force concluded that they should be incorporated in the proposed revised ISA.
5. Generally, the Task Force has concluded that most of the potential revisions should be adopted, with the exception of a few that it considers would be more appropriately addressed in other ISAs. This will result in a significant increase in the scope of the ISA. The Task

Force intends where possible to use the most recently revised national audit standards as a source of potential text for the proposed revised ISA.

Consideration of Qualitative Factors at the Planning Stage

6. The “traditional” approach to materiality tends to involve a 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 than other elements of the financial statements which, for some users, may be at least as important.
7. The Task Force believes that the proposed revised ISA should adopt 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. Materiality levels should be determined appropriate to the individual components (line items and disclosures) of the financial statements, taking account of the perceived significance to users of the financial statements. Whilst still recognizing a need to determine a materiality level, possibly by reference to profit or another base, for the overall evaluation of aggregate misstatements, this approach would result typically in more than one materiality level being established at the planning stage. It would involve more consideration of individual components of the financial statements throughout the audit and encourage more emphasis on factors other than quantitative measures and percentage rules of thumb when evaluating the effects of misstatements.
8. Such an approach is already supported by the current ISA 320¹, but would be more strongly emphasized in the proposed revised ISA.
9. This approach would necessarily be more judgmental than the formulaic approach adopted by some auditors. The Task Force intends to ensure that the Standards and guidance are practicable and that the revised approach is not incompatible with other ISAs (see below) including, in particular, the planning process that will be described in the proposed new Audit Risk ISAs. The Task Force will bring to the attention of the IAASB any further issues that may arise during development of the proposed revised ISA that it believes requires the IAASB’s consideration.

Action Required by IAASB

Does the IAASB support the suggested approach to the consideration of materiality and the concept that the use of more than one level of materiality should become the norm?

¹ 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 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.’

The Definition of Materiality

10. The definition of materiality in ISA 320 is taken from the International Accounting Standards Committee's "Framework for the Preparation and Presentation of Financial Statements"² (the Framework).

"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 of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful."

11. The Task Force is concerned that this definition does not make clear the importance of considering the nature, as well as the size, of an item. In the Framework materiality is addressed in the context of being a factor affecting the relevance of information to the decision making needs of users. The focus is on size with the nature of the information treated as a separate factor³ to materiality. In relation to this, there is an inconsistency in the way materiality is defined in the Framework and in International Accounting Standard (IAS) 1 "Presentation of Financial Statements."

12. In IAS 1 (in both the extant Standard and the recent exposure draft for its revision) materiality is addressed in the context of considering whether items should be presented separately in the financial statements or aggregated. Paragraph 26 of the exposure draft states:

"In this context, information is material if its non-disclosure could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size and nature of the item judged in the particular circumstances of its omission. In deciding whether an item or an aggregate of items is material, the nature and the size of the item are evaluated together. Depending on the circumstances, either the nature or the size of the item could be the determining factor. ..."

13. The Task Force believes that materiality should be defined by reference to both the size and the nature of the item. It would be better for ISA 320 to adopt a definition based on the one in IAS 1 rather than the Framework. The IASB should be encouraged to amend the Framework or, if that is not practicable at this time, to broaden the definition in IAS 1 to define materiality generally and not just in the context of aggregation and disclosure of items in the financial statements. Suitable wording might be:

"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 nature and size of the item judged in the particular circumstances of its omission or misstatement. In deciding whether an item or an aggregate of items is material, the nature and the size of the item are evaluated together. Depending on the circumstances, either the nature or the size of the item could be the determining factor."

² The IASB has adopted the IASC Framework without change.

³ Paragraph 29 of the Framework states "The relevance of information is affected by its nature and materiality. In some cases, the nature of information alone is sufficient to determine its relevance. For example, the reporting of a new segment may affect the assessment of the risks and opportunities facing the enterprise irrespective of the materiality of the results achieved by the new segment in the reporting period. In other cases, both the nature and materiality are important, for example, the amount of inventories held in each of the main categories that are appropriate to the business."

14. Representatives of the Task Force have discussed this with representatives of the IASB. The IASB intends to update the Framework but this is unlikely to be commenced before completion of the IASB's convergence project, which will be too late for our purposes. However, it is possible that the definition/discussion of materiality in IAS 1 will be broadened to encompass measurement as well as disclosure and so provide a more appropriate definition of materiality that could be adopted in the proposed revised ISA 320.

Action Required by IAASB

Does the IAASB support the suggested revision of the definition of materiality in 13?

Is it acceptable to revise the definition in ISA 320 if a contemporaneous revision is not made by the IASB in their Framework or IAS 1?

Overlap with Other ISAs

15. The concept of materiality is addressed in some other ISAs that are being revised/developed, including the Audit Risk Model, Group Audits, Audit of Accounting Estimates and The Auditor's Report on Financial Statements. It is important that the different Task Forces liaise to ensure that they agree the proposed revised Standards and guidance on matters of common concern and to ensure consistency and compatibility of proposed revisions.

THE AUDIT RISK MODEL

16. The Materiality Task Force does not believe that its planned revisions will be incompatible with the proposals for the Audit Risk Model for the "assessment of the risk of material misstatements," providing that the risk model recognizes that Standards and guidance on determining "what is material" is the subject of ISA 320.

GROUP AUDITS

17. The IAASB has requested the Group Audits Task Force to develop guidance on the treatment of materiality in group financial statements. This is one of the more difficult issues and close liaison will be needed between the two Task Forces.
18. The concept that there should normally be more than one level of materiality determined at the planning stage is likely to have implications for the work on group and multi-location audits, including:
- the determination by the principal auditor of materiality levels for use by the auditors of components for group audit purposes; and
 - considerations by auditors of components for reporting misstatements and other matters to the principal auditor.

ESTIMATES INVOLVING MEASUREMENT UNCERTAINTY

19. There are a number of issues related to materiality that need to be considered when auditing estimates involving measurement uncertainty. Therefore, the Materiality Task Force is liaising with the Task Force that is revising ISA 540 "Audit of Accounting Estimates" to share ideas and ensure consistency of the proposed revisions. Both Task Forces recognize that a "zone of reasonableness" applies to estimates involving measurement uncertainty.

20. One of the issues that is of mutual interest is the analysis and evaluation of misstatements and other matters to communicate to those charged with governance. Three categories of audit findings have been identified:
- (a) Factual errors.
 - (b) Estimates by management that are outside the auditor's zone of reasonableness.
 - (c) Estimates by management that are within the zone of reasonableness determined by the auditor but for which particular characteristics may need to be considered carefully when assessing whether the financial statements give a fair presentation. A particular consideration may be whether management is seeking to manage the entity's earnings or other key performance indicators in an unacceptable manner (e.g., whether management has made a significant change from one period to another of an estimate in the zone of reasonableness, or whether the particular selection of estimates from within zones of reasonableness appear to be designed to achieve a pre determined result and cause the financial statements to be other than neutral (i.e. there is evidence of bias)).
21. With respect to items in the first two categories, auditors have a detection responsibility and such differences give rise to misstatements (as defined by ISAs). Auditors consider whether such misstatements are material either individually or in aggregate.
22. Auditors do not have a detection responsibility, per se, with respect to items in the third category. However, to the extent that such items are detected by the auditors they need to know how to deal with them. Because such items fall within the auditor's zone of reasonableness they do not meet the definition of a misstatement. Nevertheless, the auditor may question whether individually or in aggregate such items cause the financial statements not to give a fair presentation.
23. The two Task Forces believe that the proposed revision of ISA 540 ought to provide Standards and guidance on determining which items, and their value, should be recorded under each of the three categories. The proposed revised ISA on materiality should provide Standards and guidance on the evaluation of the items, whether they are material and whether and how they should be reported to those charged with governance.

Action Required by IAASB

Does the IAASB agree with this approach?

Unadjusted Misstatements From Prior Periods

24. When evaluating uncorrected misstatements it is necessary to consider those that arose in prior periods and whether they affect the current period's financial statements.
25. There are various methods of evaluating unadjusted misstatements; for example:
- Comparison of all misstatements, regardless of the period to which the misstatements relate, against the current period results of operations, balance sheet and cash flows (this aims to ensure that the closing balance sheet, including retained reserves, is fairly stated through corrections made in the current period).

- Comparison of just those portions of the misstatements that affect the current period against the current period results of operations (this aims to ensure that income for a particular period is fairly stated – to “fully correct” balance sheet reserves would require a prior period adjustment).
26. The Task Force believes that generally audit firms do not explicitly require one particular method of evaluation to be used. However, generally firms do indicate that the effects on the current period of unadjusted misstatements from prior periods are considered.

Action Required by IAASB

Does the IAASB believe that the proposed revised ISA should stipulate a particular method for considering the effects of unadjusted misstatements from prior periods? If yes, which one? Should it stipulate that auditors should consider both whether the income for a period is fairly stated and whether the balance sheet is materially incorrect because of cumulative unadjusted misstatements?

27. The IASB’s proposed improvements to IAS 8 “Accounting Policies, Changes in Accounting Estimates and Errors” may be relevant. If adopted, an entity no longer would be permitted to include the correction of a prior period material error in profit or loss for the current period but would have to account for it retrospectively so that financial statements are presented as though the error had never occurred (currently entities may choose to correct only “fundamental” errors retrospectively).

Correction of Immaterial Misstatements

28. As a principle it would be desirable that management adjust all known misstatements, other than those which are clearly trifling,⁴ and some national audit standards indicate that auditors should encourage management to do so. Encouraging an environment in which misstatements are not tolerated is conducive to improving governance. Also, it can be argued that not requesting immaterial misstatements to be adjusted can give the wrong signal to management and may inadvertently create an environment conducive to aggressive earnings management. However, immaterial misstatements do not cause the financial statements not to give a fair presentation and auditors have no sanctions they can apply if management do not correct immaterial misstatements – so it is questionable whether it is appropriate for an ISA on materiality to address this issue.
29. Persistent/frequent immaterial misstatements could be indicative of a poor control environment and/or systematic problems. This is a matter that auditors need to consider, particularly if reporting on the adequacy of systems of internal control, and may conclude needs to be discussed with the audit committee and management. It is clearly important that

⁴ The UK Auditing Practices Board, in its Statement of Auditing Standards 610 “Communication of Audit Matters to Those Charged With Governance,” explains the term “trifling” as follows: “This is not another expression for ‘immaterial’. Matters which are ‘clearly trifling’ will be of an wholly different (smaller) order of magnitude than the materiality thresholds used in the audit, and will be matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any quantitative and/or qualitative criteria. Further, whenever there is any uncertainty about whether one or more items are ‘clearly trifling’ (in accordance with this definition), the presumption should be that the matter is not ‘clearly trifling’.”

addressing immaterial misstatements should not be done in a way that results in a loss of emphasis on more important matters or in a loss of respect between audit committees, management and the auditors. These are matters that should be considered by the Task Force that is working on Standards and guidance for reporting on internal control.

30. Although some misstatements may not be regarded as material to the financial statements, there may be a question as to whether they are material to an entity's obligation to keep proper books and records. This is a concern to some regulators.

Action Required by IAASB

What are the IAASB's views on whether or not the proposed revised ISA on materiality should indicate that auditors encourage management to correct all known misstatements? Does the IAASB agree that the possible implications of persistent/frequent misstatements should be addressed by the Task Force that is working on reporting on internal control?

Other Information

31. The Task Force has considered whether the proposed revised ISA should address the concept of materiality in relation to other information that may accompany the audited financial statements (e.g., Management Discussion and Analysis). For example, could guidance be provided as to what may cause non financial information to be regarded as materially incorrect or misleading?
32. Since there are many different reporting frameworks governing the reporting of "other information", it is not practicable to develop helpful detailed guidance on materiality considerations that would address all circumstances. Accordingly, the Task Force concluded that the proposed revised ISA 320 should not attempt to address issues specific to other information outside of that covered by the auditor's opinion.
33. The Task Force believes that this is an issue that should be considered with respect to ISA 720 "Other Information in Documents Containing Audited Financial Statements."

Required by IAASB

Does the IAASB agree that considerations in relation to "other information" should be specifically excluded from the proposed revised ISA 320?

Working With IASB

34. It would be helpful for there to be consistent guidance on materiality for preparers of financial statements and for auditors. The IASB currently provides relatively little guidance on materiality and the Task Force believes that they should be encouraged to provide more.
35. The IAASB should liaise with the IASB to seek to ensure that guidance published by both bodies is consistent. An issue concerning the definition of materiality is described above.
36. The Task Force believes that the IASB should emphasize the importance of the nature of an item when judging whether it would influence the economic decisions of a user of the

financial statements. In some circumstances even very small amounts might be material. Consideration may, *inter alia*, be given to:

- the legality, sensitivity, normality and potential consequences of the event or transaction (e.g., whether it affects compliance with regulations or with loan covenants; or increases rewards for management);
 - the effect on the evaluation of trends and key financial indicators (e.g., whether it masks a failure to meet expectations of the entity in relation to the level of earnings or earnings per share, or changes a loss into a profit or vice versa);
 - the identity of the parties involved (e.g., whether external parties to transactions are related to members of the entity's management);
 - the particular financial statement items affected and the perceived significance of the item to users of the financial statements; and
 - whether the item is capable of precise measurement or whether it arises from an estimate and, if so, the degree of imprecision inherent in the estimate.
37. Representatives of the Task Force have met with representatives of the IASB to discuss these concerns. It was agreed that additional guidance for preparers of financial statements would be helpful and that the IASB needs to say more about materiality. The IASB intends to revise the Framework and more guidance on materiality, including qualitative considerations, will be included at that time. Unfortunately this will not be commenced until the convergence project has been completed and so new guidance is unlikely to be seen before 2005 at the earliest.
38. The IASB have agreed that the Task Force can liaise with the IASB Director of Technical Activities and seek views on the proposed revised Standards and guidance developed for auditors if that would be considered helpful.

"Users" of Financial Statements

39. Consideration of who are the users of financial statements and, in particular, the level of financial knowledge it would be reasonable to assume they have, is essential for a proper consideration of what may be material to them. Currently ISA 320 provides no guidance on these matters; the Task Force believes that the proposed revised ISA should provide such guidance.
40. Guidance on these matters is provided by the IASB in the Framework. This guidance states, *inter alia*, that "... users are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence."

Action Required by IAASB

Does the IAASB agree that guidance should be provided on these matters in the proposed revised ISA?

Small Audits

41. The Task Force intends to ensure that the Standards and guidance are practicable for application to the audit of small entities as well as the audits of large/listed entities. The proposed approach emphasizes consideration of the nature of items and the circumstances of the entity; and determining materiality levels appropriate to individual components of the financial statements, taking account of the perceived significance to users (see paragraph 7 above). Taking account of this, the Task Force believes that it should not be necessary to include within the proposed revised ISA a specific section on the audit of small entities, as the key principles (to be set out in bold text) will be the same for audits of all sizes. To the extent considered necessary to clarify the application of the key principles to the audit of small entities (e.g., are the users of the financial statements financial market investors or owner managers?), the Task Force intends to include appropriate examples in the grey text.

Action Required by IAASB

Does the IAASB agree that the key principles should be applicable to audits of entities of all sizes? To comply with the IAASB's requirement for specific considerations for audits of small entities to be addressed within ISAs, is it acceptable to address such specific considerations by way of examples in the grey text or is it necessary to have separate headed sections more obviously commenting on the considerations for audits of small entities?

Guidance For Users of Audited Financial Information

42. Public perceptions are important. For example, there may be an amount that a user would always regard as material simply by virtue of its size without regard to anything else. The Task Force believes that it would be helpful if there was a document for “users” of financial information on which auditors report, that explained certain key aspects of an audit. This could help reduce the risk of an “expectations gap” with regard to what users of financial statements perceive to be material and the judgments made by auditors. This topic clearly is much broader than just materiality. Matters that could be addressed include:

- The risk based approach to auditing.
- The concept of materiality.
- The inherent limitations of an audit.
- Cost/benefit considerations and the impact on the audit.

Such guidance would also be of value to audit committees.

43. In the early 90's the IAPC published a booklet “Understanding Financial Statements Audits – A Guide for Financial Statement Users.” This may provide a suitable starting point to produce up-to-date guidance that takes account of the subsequent revisions to ISA's.

Action Required by IAASB

The Task Force recommends that the IAASB produce an up-to-date document specifically for users of financial statements that explains certain key aspects of an audit.

Possible Revisions to ISA 320

<i>Possible revisions identified by staff</i>	<i>Does the Task Force agree the revision?</i>
Introduction	
Ensure currency of reference to IASC framework	✓ Subject to agreeing the definition of materiality.
Clarify the extent of the auditor’s responsibility to plan and perform the audit to detect potential misstatements, and management’s responsibility to correct misstatements.	✓ Care will need to be taken to ensure that this does not appear to be over-defensive.
Materiality	
Expand discussion of qualitative factors	✓
Expand discussion of the relation between materiality and the users of financial statements	✓ If possible, clarify who the “users” are.
Provide guidance on the potential impact of breaches of laws and regulations in relation to books and records.	? Guidance on this exists for the US. It may be possible to internationalise this, but care will need to be taken with potential overlap with ISA 250 “Consideration of Laws and Regulations in an Audit of Financial Statements.”
Materiality and audit risk	
Clarify the issue of materiality at the account balance, class of transactions and assertions levels consistent with work of Audit Risk Task Force	✓ Need generally to ensure consistency with the Audit Risk Model.
Discuss cost / benefit considerations and the effect on the design of audit procedures (i.e., necessary to work within economic limits)	✗ ISA 320 is not the appropriate place for this.
Evaluating the effect of misstatements	
Encourage management to correct all misstatements, even if considered immaterial	✓
Expand guidance on evaluation of individual misstatements having regard to both qualitative and quantitative factors	✓
Provide guidance on the successive stages of aggregation, from account balance or class of transactions to highest level of aggregation	✓
Additional issues not addressed in ISA 320	
Communication of materiality	✗ These should be addressed in the more specific ISAs.

Possible revisions identified by staff	Does the Task Force agree the revision?
<ul style="list-style-type: none"> Engagement letter Management representations Communications to management / audit committee 	
Consideration of net uncorrected misstatements in opening equity when circumstances suggest a significant reduction in materiality level from that in the previous audit	✓ But does not need to be addressed in detail.
Financial reporting periods less than or greater than one year	✓ But does not need to be addressed in detail.
Review of interim financial statements including consideration of uncorrected misstatements in the annual financial statements	✓ But does not need to be addressed in detail.
Establishment of materiality levels for use at the entity wide and subsidiary levels in the audit of consolidated entities/multi-locations	? This may be more appropriately addressed in detail in the separate standards/guidance for group audits; the Materiality Task Force should be involved with its development. Include in ISA 320 by cross reference.
Classification of misstatements for evaluation (known, likely, maximum possible etc.,)	✓
Consideration of accounting estimates and, in particular, the issues where there is a range of acceptable amounts rather than point estimates.	✓ Need to liaise with the Accounting Estimates Task Force.
Limitations of “rule of thumb” measures.	✓
Intentional misstatements, including earnings management	✓
Reevaluation of sufficiency of procedures if materiality level is lowered during the audit	✓
Consideration of unverified and minimum review items and estimation of the largest possible aggregate misstatement that could escape detection	✓ But does not need to be addressed in detail.
Effect of uncorrected misstatements from prior periods	✓
Documentation requirements	✓

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