

PROPOSED REVISED INTERNATIONAL STANDARD ON AUDITING 320  
MATERIALITY IN THE IDENTIFICATION AND EVALUATION OF  
MISSTATEMENTS

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International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

ISAs contain the basic principles and essential procedures (identified in bold type black lettering) together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be interpreted in the context of the explanatory and other material that provide guidance for their application.

To understand and apply the basic principles and essential procedures together with the related guidance, it is necessary to consider the whole text of the ISA including explanatory and other material contained in the ISA, not just that text which is black lettered.

In exceptional circumstances, an auditor may judge it necessary to depart from an ISA in order to more effectively achieve the objective of an audit. When such a situation arises, the auditor should be prepared to justify the departure.

ISAs need only be applied to material matters.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an ISA. Where no PSP is added, the ISA is applicable in all material respects to the public sector.

## Introduction

1. The purpose of this ISA is to establish standards and provide guidance on materiality, including its relationship with audit risk and its relevance to the identification and evaluation of misstatements.
2. **The auditor should consider materiality:**
  - (a) **When assessing audit risk;**
  - (b) **When determining the nature, timing and extent of audit procedures;**
  - (c) **As the audit progresses; and**
  - (d) **When evaluating the effect of identified misstatements on the auditor's report.**

## Materiality in the Context of an Audit

3. **The auditor should consider information to be material if it is probable that its misstatement, which includes omission, would reasonably change or influence decisions, taken on the basis of the audited financial statements as a whole, by users who have a reasonable understanding of business and economic activities. In deciding whether an item or an aggregate of items is material, the auditor should consider both the nature and size of the item or items judged in the particular circumstances of their misstatement.**

## USERS

4. There are many potential users of financial statements. The auditor ordinarily cannot be aware of all the potential users or of their different needs for information presented in accordance with the financial reporting framework. When making decisions about materiality the auditor has regard to the perceived needs of:
  - The intended users of the auditor's report, as described in paragraphs 17 to 19 of the "International Framework for Assurance Engagements"; and
  - Other users to whom the auditor has a known duty of care.<sup>1</sup>As investors are providers of risk capital, consideration of their perceived needs will generally also meet most of the needs of other users of the financial statements.
5. Obtaining the views and expectations of management and those charged with governance may be helpful in gaining or corroborating an understanding of users' needs.
6. The presentation of information in the financial statements is determined by the applicable financial reporting framework. The auditor assumes that users are capable of understanding information that is presented in accordance with the applicable financial reporting framework, will recognize the inherent limitations in the use of estimates, judgment and the consideration of future events, will study the information with reasonable diligence and will make reasonable decisions on the basis of that information.

<sup>1</sup> The extent of the auditor's duty of care is dependent upon the laws, and interpretations thereof by the Courts, in the country in which the auditor's report is issued. 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.

7. Financial statements ordinarily are not prepared to meet all the potential information needs of users. Users may have to supplement the information they obtain from the audited financial statements with information from other sources.

#### EXTENT OF AUDITOR'S RESPONSIBILITY

8. In planning and performing the audit, the auditor is primarily concerned with identifying matters that could result in material misstatement in the financial statements. The auditor has no responsibility to plan and perform the audit to detect misstatements, whether caused by errors or fraud, that are not material, individually or in aggregate, to the financial statements.
9. Those who are responsible for approving and issuing the financial statements are responsible for adjusting the financial statements to correct misstatements, and for decisions to waive misstatements they believe are not material. The auditor considers the effect of uncorrected misstatements, individually and in the aggregate, on the auditor's report.

#### Nature and Causes of Misstatements

10. Misstatements in the financial statements can arise from error or fraud. The term "error" refers to an unintentional misstatement in financial statements. The term "fraud" refers to an intentional act by one or more individuals among those charged with governance, management, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage. The auditor's consideration of fraud is addressed in ISA 240 "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements".
11. A misstatement ordinarily causes the financial statements to be not in accordance with the applicable financial reporting framework. Misstatements may consist of:
  - (a) A mistake in gathering or processing data from which financial statements are prepared;
  - (b) A difference between the amount, classification, or presentation of a reported financial statement item and the amount, classification, or presentation that should have been reported under the financial reporting framework;
  - (c) An omission of an amount, classification or disclosure that should have been reported under the applicable financial reporting framework;
  - (d) An incorrect accounting estimate arising from an oversight or misinterpretation of facts; and
  - (e) Differences between management's and the auditor's judgments concerning accounting estimates<sup>2</sup> or the application of accounting principles.
12. Misstatements also include, in exceptional circumstances, items that comply with the applicable financial reporting framework but cause the financial statements to not give a true and fair view of (or present fairly) the financial position of the entity (e.g. where it is necessary to override the requirements of accounting standards in order to give a true and fair view (or present fairly) but this is not done).
13. Misstatements are classified for audit purposes as:

<sup>2</sup> See ISA 540 "Accounting Estimates".

(a) Known misstatements

These are specific misstatements identified during the audit including, for example, those arising from mistakes in gathering or processing data and, in the context of accounting estimates, the oversight or misinterpretation of facts. 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.

### Determining Materiality

14. **The evaluation of what is material is a matter of professional judgment. In order to assess the risks of material misstatement, and to plan the nature, timing and extent of audit procedures, the auditor should determine materiality at the overall financial statement level and at the level of individual classes of transactions, account balances and disclosures. Materiality levels should be determined taking into account the auditor's understanding of the importance to users of different items disclosed in the financial statements, having regard to the size and nature of those items judged in the particular circumstances.**

15. ISA XX "Understanding the Entity and Its Environment and Assessing the Risk of Material Misstatement" requires the auditor to assess the risks of material misstatement at two levels: at the overall financial statement level, and at the assertion<sup>3</sup> level for classes of transactions, account balances and disclosures.<sup>4</sup> However, the auditor does not determine separate materiality levels for each separate assertion: the auditor uses the levels of materiality that the auditor has determined apply to individual classes of transactions, account balances and disclosures (see below).

16. The auditor expresses an opinion on the financial statements taken as a whole, not on individual classes of transactions, account balances and disclosures. Nonetheless, 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 lower levels of materiality are appropriate for use in planning, and evaluating, audit procedures. This results

3 The concept of assertions is explained in paragraph 7 of ISA XX "Audit Evidence". Broadly, they are the assertions made implicitly by management in financial statements relating to recognition and measurement of the various elements of financial statements and related disclosures (e.g. that transactions have been recorded in the correct period; that assets exist and are appropriately valued and the entity holds or controls the rights to them).

4 ISA XX, paragraph 95.

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).

17. 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.
18. When considering the importance to users of different items disclosed in the financial statements the auditor has regard to circumstances such as:
  - The requirements of the applicable financial reporting framework (e.g. whether accounting standards and guidance contain explicit references to the judgment of materiality of particular items);
  - The nature of the entity, the industry in which it operates and, in relation thereto, key disclosures, trends, ratios and other financial indicators (e.g. matters pertaining to the solvency ratio of an insurance company);
  - The size of the entity and nature of its stakeholders, the way the entity is financed and whether or not it is listed on a regulated market; and
  - Information communicated by management or external analysts that may affect users' expectations, and the auditor's awareness of users' reactions to similar previously published information.
19. The auditor may select benchmarks on which to base initial evaluations of materiality. When identifying appropriate benchmarks, the auditor considers the perceived needs of the users of the financial statements and the entity's particular circumstances. For example, income after tax from continuing operations may be of particular significance to the financial statement users of entities whose equity securities are publicly traded and this may be a suitable benchmark on which to base materiality at the overall financial statement level. Income after tax may not be an appropriate benchmark for the determination of materiality when the entity's earnings are volatile, when the entity is a not-for-profit organization or when it is an owner managed business where the owner takes much of the pre tax income out of the business in the form of remuneration. Other benchmarks that might be appropriate, depending on the circumstances of the entity, include current assets, net working capital, total assets, total liabilities, total revenues, gross profit, total equity, and cash flows from operations.
20. When considering appropriate benchmarks the auditor considers whether there are risks of overstatement or understatement and the effect that may have on the determination of materiality. For example, a materiality level may be inappropriately large if it is based on a benchmark that is overstated.
21. In relation to particular classes of transactions, account balances and disclosures, the auditor considers whether there is an amount above which any item would always be considered by the users to be material, having regard to the nature of the item and the circumstances in which it is judged.

22. The intrinsic nature of some items may cause them to be judged material even when they have a relatively small size. For example:
- (a) Those where there are concerns about the legality, sensitivity and normality of the event or transaction and the potential consequences;
  - (b) The inadequate or improper description of an accounting policy when it is likely that a user of the financial statements would be misled by the description;
  - (c) Failure to disclose the breach of contractual or regulatory requirements when it is likely that the consequent imposition of contractual or regulatory restrictions may significantly impair operating capability;
  - (d) Matters that affect the integrity of the financial records;
  - (e) Matters which suggest fraudulent financial reporting practice (see ISA 240), or that management is attempting to “manage” or manipulate the entity's reported earnings or trends and key financial indicators. For example, intentional misstatements could be used by management as a means of achieving forecast results.
23. Ordinarily, when making preliminary judgments about materiality, the auditor considers prior period financial results, period-to-date financial results, and budgets or forecasts for the current period, taking account of known changes in the business. Where the draft current period financial results appear to be significantly different to previous periods, the auditor considers the reason for that. If draft financial results for the current period are not yet available for planning purposes, the auditor considers making preliminary judgments about materiality based on the entity's annualized interim financial statements or financial statements of one or more prior annual periods, adjusting if necessary for the effects of significant changes in the entity's circumstances (e.g. a significant business acquisition) and relevant changes in the economy as a whole or the industry in which the entity operates.

#### **Considerations as the Audit Progresses**

24. **The auditor should reconsider the appropriateness of the materiality levels, revising them if necessary, in the event of becoming aware of information during the audit that would have caused different levels to be determined initially.**
25. The auditor's evaluation of materiality at the time of initially planning the audit may differ from that at the time of evaluating the results of further audit procedures. This may be because of a change in circumstances that occurs during the audit or because of new information or changes in the auditor's understanding of the entity and its operations as a result of performing audit procedures. For example, the auditor might have based materiality on the anticipated period end financial results. If actual financial results are substantially different, the evaluation of materiality may also change.
26. If, after planning the audit procedures, the auditor determines that the relevant acceptable materiality level is lower, audit risk is increased. The auditor compensates for this by:
- (a) Reducing the assessed risk of material misstatement, where this is possible, by performing extended or additional tests of the operating effectiveness of internal controls; or
  - (b) Modifying the nature, timing and extent of planned substantive procedures, for example by performing tests of details as opposed to substantive analytical procedures,

performing substantive procedures closer to period end, and/or increasing the extent of substantive procedures.

27. The auditor also considers whether known and likely misstatements are material. If the auditor concludes that the misstatements may be material, the auditor considers reducing audit risk by extending audit procedures (see also paragraphs 58 -64 of ISA XX “The Auditor’s Procedures in Response to Assessed Risks”).

### **Documentation and Communication of Misstatements**

28. **The auditor should document misstatements identified during the audit and communicate them to the appropriate level of management on a timely basis.**

29. Misstatements are documented in a manner that allows the auditor to:
- (a) Separately consider the effects of known misstatements, likely misstatements and differences in judgment on the financial statements;
  - (b) Consider the effects of individual misstatements and aggregated misstatements on the financial statements; and
  - (c) Assess the effect of misstatements on particular groups of accounts, segment information, ratios, trends and compliance with debt covenants.

An illustrative example of a schedule of unadjusted misstatements is set out in Appendix 1.

30. The auditor also documents those matters identified which, although not considered to be misstatements, may otherwise be relevant to the auditor’s report because of their nature (e.g. matters such as those identified in paragraph 22, or an indication of a possible pattern of bias by management when developing and accumulating accounting estimates). An illustrative example of a summary of other audit findings is set out in Appendix 2.
31. Communication of misstatements to the appropriate level of management on a timely basis is important as it enables management to take action as necessary (e.g. to correct known misstatements and to undertake actions that could reduce the amount of likely misstatements identified by the auditor). The determination of which level of management is the appropriate one is a matter of professional judgment and is affected by such factors as the nature, size and frequency of the misstatement. Ordinarily, the appropriate level of management is at least one level above the persons who appear to be involved with the misstatement.
32. **The auditor should encourage management to correct all known misstatements. When known misstatements identified by the auditor are not corrected by management, the auditor should communicate all such uncorrected known misstatements, together with identified likely misstatements and differences in judgment, other than those that the auditor believes are clearly trifling,<sup>5</sup> to those charged with governance, in accordance**

<sup>5</sup> This is not another expression for not material. Matters which are “clearly trifling” will be of a wholly different (smaller) order of magnitude than the materiality levels used in the audit, and will be matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size and/or nature. 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”.



**with ISA 260, “Communication of Audit Matters to Those Charged with Governance”. The auditor should consider the need to report misstatements, in some circumstances, to regulatory and enforcement authorities.<sup>6</sup>**

33. The auditor discusses known misstatements that have not been corrected by management and likely misstatements and differences in judgment with those charged with governance. Consideration is given to the nature and circumstances as well as the size of the misstatements, and the effect of such misstatements on the auditor’s report.
34. If management has corrected known misstatements, the auditor considers whether any of those corrections of which the auditor is aware should be communicated to those charged with governance so as to assist them to fulfill their governance responsibilities (e.g. material misstatements, or frequently recurring immaterial misstatements, may be indicative of significant weaknesses in the systems of internal control or the design or operation of the entity’s financial reporting process).
35. **The auditor should communicate other significant audit findings to those charged with governance, in accordance with ISA 260, “Communication of Audit Matters to Those Charged with Governance”.**
36. As described in paragraph 30 the auditor may identify matters that, although not considered to be misstatements, may otherwise be relevant to the auditor’s report because of their nature. Where the auditor believes these other audit findings are significant they are discussed with those charged with governance.
37. **The auditor should obtain written representations from those who are responsible for approving and issuing the financial statements that they believe the effects of those uncorrected misstatements identified by the auditor during the audit are not material, either individually or in aggregate, to the financial statements taken as a whole. A summary of such misstatements should be included in or attached to the written representation.<sup>7</sup>**
38. Because those who are responsible for approving and issuing the financial statements are responsible for adjusting the financial statements to correct misstatements, it is important that the auditor obtain written representation from them that any uncorrected misstatements are, in management’s opinion, immaterial, both individually and in the aggregate. Such representations are not a substitute for obtaining sufficient appropriate audit evidence. If management disagree that certain of the uncorrected financial statement misstatements aggregated by the auditor during the audit are misstatements (e.g. they may disagree with the auditor’s judgments concerning financial statement amounts involving measurement uncertainty), the auditor asks them to provide a written representation that gives their reasons for not agreeing that those items are misstatements.

6 Requirements specific to the communication of misstatements resulting from fraud, or a suspected fraud, are set out in ISA 240 “The Auditor’s Responsibility to Consider Fraud [and Error] in an Audit of Financial Statements”.

7 The summary need not include any misstatements that the auditor believes are ‘clearly trifling’.

**Evaluating the Effect of Misstatements on the Auditor's Report**

39. **In evaluating whether the financial statements give a true and fair view (or are presented fairly, in all material respects), in accordance with the applicable financial reporting framework, the auditor should evaluate whether the uncorrected misstatements that have been identified during the audit are material, individually or in aggregate, to the users of the financial statements. In making this evaluation, the auditor should consider the size and nature of the misstatements and the particular circumstances of their occurrence.**
40. The auditor reviews misstatements in the context of the perceived importance of the related financial statement information to users. Consideration is given to the size and nature of the items. The circumstances related to misstatements may also be relevant to materiality considerations. For example:
- Whether the item is capable of objective determination or whether it involves a degree of subjectivity through estimation, allocation or uncertainty;
  - Whether the misstatement affects compliance with regulatory requirements;
  - Whether the misstatement affects compliance with debt covenants or other contractual requirements;
  - Whether the item masks a change in earnings or other trends, especially in the context of general economic and industry conditions;
  - The effect of the misstatement on ratios used to evaluate the entity's financial position, results of operations or cash flows;
  - The effect of the misstatement on segment information (e.g. the significance of the matter to a segment or other portion of the entity's business that has been identified as playing a significant role in the entity's operations or profitability);
  - Whether the item has the effect of increasing management compensation, for example, by ensuring that the requirements for the award of bonuses or other incentives are satisfied;
  - Whether the item changes a loss into a profit or vice versa;
  - The pervasiveness of the misstatement (e.g. the misstatement might affect the presentation of numerous items in the financial statements);
  - The effects of misclassifications (e.g. misclassification between operating and non-operating income or recurring and non-recurring income items; a misclassification between restricted and unrestricted resources in a not-for-profit organization; or a misclassification between balance sheet items that may not affect income);
  - The significance of the misstatement relative to the auditor's understanding of users' needs and expectations. For example:
    - (i) The significance of earnings per share to public company investors; or
    - (ii) The effect of misstatements of net income or loss when contrasted with expectations.
  - The identity of the parties involved (e.g. whether external parties to the transaction are related to members of the entity's management).

41. Before aggregating the numerical amounts of uncorrected misstatements the auditor considers each misstatement separately:
- (a) In relation to individual classes of transactions, account balances and disclosures;
  - (b) To evaluate whether it is appropriate to offset certain items. For example, the auditor considers whether it is appropriate to offset a misstatement relating to an estimated amount with a misstatement relating to an item capable of precise measurement, or whether it is appropriate to offset misstatements of items that are disclosed separately in the financial statements;
  - (c) To evaluate the effect of a misstatement from prior periods and any cumulative effect becoming material in the current or subsequent reporting periods (see also paragraphs 44-45).

The auditor also considers whether the misstatements reflect on the adequacy of the financial records maintained by the entity, or are indicative of internal control weaknesses, and the implications for the assessment of audit risk and whether it has been reduced to an acceptably low level, and for the auditor's reporting responsibilities.

42. Uncorrected misstatements are aggregated in a way that enables the auditor to assess the risks of material misstatement at the financial statement level, and at the level of individual classes of transactions, account balances and disclosures.
43. When the level of aggregate known and likely misstatements and differences of judgment approaches materiality or when misstatements can be traced to systemic breakdowns in internal control rather than isolated occurrences, the auditor considers whether further possible misstatements may exist that, in aggregate with identified misstatements, would be material. In most instances the amount of further possible misstatement cannot be precisely quantified and is evaluated by the auditor using professional judgment.

#### UNCORRECTED MISSTATEMENTS FROM PRIOR PERIODS

44. The auditor includes in aggregate misstatements the effect on the current period's financial statements of uncorrected prior-period misstatements.
45. When considering the appropriate treatment of misstatements related to prior periods, the auditor has regard to the requirements of the applicable financial reporting framework (e.g. whether accounting standards require or permit prior period misstatements to be corrected by way of restating the prior period or by correction in the current period).

#### THE AUDITOR'S REPORT

46. **If the auditor is not able to conclude that uncorrected misstatements, individually and in aggregate, are not material, the auditor should consider the appropriate modification to the auditor's report in accordance with ISA 700, "The Auditor's Report on Financial Statements."**

#### Intentional misstatements and earnings management

47. **The auditor should adopt an attitude of professional skepticism to evaluate whether management has intentionally misstated certain items (possibly by amounts below the audit materiality levels) to "manage" reported earnings or trends and key financial indicators (e.g. intentional misstatements could be used by management as a means of**

achieving forecast results). Matters which suggest fraudulent financial reporting practice, and the auditor's response to them, are addressed in ISA 240.

#### Legal and Regulatory Reporting Responsibilities

48. In some countries the auditor may have legal or regulatory reporting responsibilities beyond providing an opinion on the entity's financial statements, for example, to report if the entity has not maintained adequate financial records or systems of internal control. Where relevant, the auditor should consider the effect of identified misstatements with regard to such reporting responsibilities. Failure to record accurately items that would not otherwise be considered material may, in some instances, result in violations of those laws and regulations with contingent consequences for the entity.

#### Documentation

49. In addition to the other documentation requirements set out in paragraph 28 of this ISA, the auditor should document:
- (a) The materiality levels, including any changes thereto, used in risk assessments and determining the nature, timing and extent of the audit procedures and in evaluating the results of the audit, and the basis on which those levels were determined;
  - (b) An analysis of unadjusted:
    - (i) known misstatements;
    - (ii) likely misstatements; and
    - (iii) differences in judgment.
  - (c) Other matters which, although not considered to be misstatements, may otherwise be relevant to the auditor's report because of their nature. For example concerns relating to management bias;
  - (d) The conclusion, and basis thereof, as to whether uncorrected misstatements cause the financial statements to be materially misstated.

#### Effective Date

50. This ISA is effective for audits of financial statements for periods ending on or after [date].

#### Public Sector Perspective

This section to be considered by the Public Sector Committee
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## SUMMARY OF UNADJUSTED MISSTATEMENTS

Working paper reference	Description	Income before tax over (under) stated			Balance Sheet		
		Known misstatements	Likely misstatements	Differences in judgment	Assets (over) under-stated	Liabilities over (under) stated	Equity over (under) stated
Total pre-tax differences - this year							
Tax effect							
Total after tax - this year's differences							
After-tax income statement differences not adjusted in previous year (effect on current year)							
Net effect on income							

**Appendix 2****SUMMARY OF OTHER AUDIT FINDINGS**

1. Possible breaches of law or regulations.
2. Transactions that appear unusual as to nature or amount.
3. Inadequate or inaccurate descriptions of an accounting policy.
4. Failure to maintain proper financial records.
5. Management bias.