

**Revision of ISA 320, *Audit Materiality* – Issues Paper****The Definition of Materiality and Guidance on Users**

1. 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"<sup>1</sup> (the IASB 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."

2. As indicated to the IAASB in December 2002, 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.
3. The Task Force also indicated to the IAASB that it believed that the proposed revised ISA should provide guidance on the auditor's 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.
4. The Task Force is currently minded to include the following basic principle and guidance in the proposed revised ISA:

**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 financial statements as a whole, by users who have a reasonable understanding of business and economic activities. Materiality depends on the size and nature of the item judged in the particular circumstances of its misstatement. In deciding whether an item or an aggregate of items is material, the auditor should consider both the nature and size of the item.**

**Users**

Financial statements are not prepared to meet all the potential information needs of users. The information for users required to be presented in the financial statements is determined by the financial reporting framework. Users will usually have to supplement the information they obtain from financial statements with information from other sources.

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 the "International Framework for Assurance Engagements"; and
- Other users to whom the auditor has a duty of care.<sup>2</sup>

The auditor is entitled to assume that users are capable of understanding information that is presented in accordance with the financial reporting framework, will recognise the inherent

<sup>1</sup> The IASB has adopted the IASC Framework without change.

limitations in information requiring the use of estimates and 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>2</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.

5. The Task Force considered other definitions of materiality issued by standard setters when developing the wording above (see Appendix I) and the guidance on users in the IASB Framework (see Appendix II).
6. The Task Force believes that the guidance on users in the IASB Framework is too broad to describe those users to whom the auditor has regard when making decisions about materiality, and would result in an unreasonable increase in the auditor's liability. The Task Force believes that it is appropriate to establish that the users to whom the auditor has regard are those to whom the auditor owes a duty of care, which may vary in different countries. In some countries, these users may be broader than the "intended users" described in the proposed "International Framework for Assurance Engagements" (see Appendix III).
7. As these are considered to be particularly important paragraphs within the proposed revised ISA, the Task Force would welcome the views of the IAASB at this stage rather than waiting until the first read of the proposed exposure draft at the July 2003 IAASB meeting.
8. The Task Force will discuss the conclusions of this meeting with representatives of the IASB.

**Appendix II – Materiality Definitions****ISA 320 (EXTANT); SOUTH AFRICA - SAAS 320; (AND THE IASB 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.

**AUSTRALIA - AUS 306**

“Materiality” means, in relation to information, that information which if omitted, misstated or not disclosed has the potential to adversely affect decisions about the allocation of scarce resources made by users of the financial report or the discharge of accountability by the management or governing body of the entity.

**CANADA - SECTION 5130**

A misstatement or the aggregate of all misstatements in financial statements is considered to be material if, in the light of surrounding circumstances, it is probable that the decision of a person who is relying on the financial statements, and who has a reasonable knowledge of business and economic activities (the user), would be changed or influenced by such misstatement or the aggregate of all misstatements. Misstatements in financial statements arise from departures from generally accepted accounting principles and include departures from fact, inappropriate determination of accounting estimates, and omissions of necessary information.

**NEW ZEALAND - AS 304**

A statement, omission, fact, or item is material if it is of such a nature or amount that its disclosure, or the method of treating it, given full consideration of the circumstances applying at the time the financial report is completed, has the potential to influence likely users of the financial report in making decisions or assessments.

**UK - APB GLOSSARY OF TERMS**

An expression of the relative significance or importance of a particular matter in the context of financial statements as a whole. A matter is material if its omission or misstatement would reasonably influence the decisions of an addressee of the auditors' report. Materiality may also be considered in the context of any individual's primary statement within the financial statements or of individual items included in them. Materiality is not capable of general mathematical definition as it has both qualitative and quantitative aspects.

**US – AU 312**

Financial statements are materially misstated when they contain misstatements whose effect, individually or in the aggregate, is important enough to cause them not to be presented fairly, in all material respects, in conformity with generally accepted accounting principles.

...

The auditor's consideration of materiality is a matter of professional judgment and is influenced by his or her perception of the needs of a reasonable person who will rely on the financial statements. The perceived needs of a reasonable person are recognized in the discussion of materiality in Financial Accounting Standards Board Statement of Financial Accounting Concepts

No. 2, *Qualitative Characteristics of Accounting Information*, which defines materiality as "the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement." That discussion recognizes that materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations.

#### IASB ED IAS 1

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. ...”

**Appendix II - Extracts from the IASB Framework for the Preparation and Presentation of Financial Statements****USERS AND THEIR INFORMATION NEEDS**

9. The users of financial statements include present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public. They use financial statements in order to satisfy some of their different needs for information. These needs include the following:
- (a) *Investors.* The providers of risk capital and their advisers are concerned with the risk inherent in, and return provided by, their investments. They need information to help them determine whether they should buy, hold or sell. Shareholders are also interested in information which enables them to assess the ability of the enterprise to pay dividends.
  - (b) *Employees.* Employees and their representative groups are interested in information about the stability and profitability of their employers. They are also interested in information which enables them to assess the ability of the enterprise to provide remuneration, retirement benefits and employment opportunities.
  - (c) *Lenders.* Lenders are interested in information that enables them to determine whether their loans, and the interest attaching to them, will be paid when due.
  - (d) *Suppliers and other trade creditors.* Suppliers and other creditors are interested in information that enables them to determine whether amounts owing to them will be paid when due. Trade creditors are likely to be interested in an enterprise over a shorter period than lenders unless they are dependent upon the continuation of the enterprise as a major customer.
  - (e) *Customers.* Customers have an interest in information about the continuance of an enterprise, especially when they have a long-term involvement with, or are dependent on, the enterprise.
  - (f) *Governments and their agencies.* Governments and their agencies are interested in the allocation of resources and, therefore, the activities of enterprises. They also require information in order to regulate the activities of enterprises, determine taxation policies and as the basis for national income and similar statistics.
  - (g) *Public.* Enterprises affect members of the public in a variety of ways. For example, enterprises may make a substantial contribution to the local economy in many ways including the number of people they employ and their patronage of local suppliers. Financial statements may assist the public by providing information about the trends and recent developments in the prosperity of the enterprise and range of its activities.
10. 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.

11. The management of an enterprise has the primary responsibility for the preparation and presentation of the financial statements of the enterprise. Management is also interested in the information contained in the financial statements even though it has access to additional management and financial information that helps it carry out its planning, decision-making and control responsibilities. Management has the ability to determine the form and content of such additional information, however, is beyond the scope of this Framework. Nevertheless, published financial statements are based on the information used by management about the financial position, performance and changes in financial position of the enterprise.

## QUALITATIVE CHARACTERISTICS OF FINANCIAL STATEMENTS

### Understandability

25. An essential quality of the information provided in financial statements is that it is readily understandable by users. For this purpose, 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. However, information about complex matters that should be included in the financial statements because of its relevance to the economic decision-making needs of users should not be excluded merely on the grounds that it may be too difficult for certain users to understand.

### Relevance

#### *Materiality*

26. 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.
27. 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.

**Appendix II – Extract from the proposed “International Framework for Assurance Engagements”****INTENDED USERS**

17. The intended users are the class of persons (or the individual) for whom the practitioner prepares the assurance report. The responsible party can be one of the intended users, but not the only one.
18. The intended users may be identified in an agreement between the practitioner and the responsible party or those engaging the practitioner. In some circumstances the intended users are identified by law. Often the intended users are the addressee of the assurance report, but in some cases there are intended users other than the addressee.
19. Some intended users (e.g., bankers and regulators) may impose a requirement on, or may request the responsible party to arrange for, an assurance engagement to be performed on a particular subject matter. However, other intended users may have no direct involvement in defining the terms of an assurance engagement. When the engagement is designed to meet the needs of specific intended users or for a specific purpose, the practitioner considers stating in the assurance report that its use is restricted to those specific intended users or the specific purpose.

[Blank page]