



**INTERNATIONAL FEDERATION
OF ACCOUNTANTS**

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Agenda Item 5

Committee: IAASB
Meeting Location: New York
Meeting Date: September 13-17, 2004

Materiality

Objectives of Agenda Item

To review draft wording of the revised proposed revised ISA 320, “Materiality in the Identification and Evaluation of Misstatements” and related conforming amendments to:

- ISA 260, “Communication of Audit Matters With Those Charged With Governance”
- ISA 580, “Management Representations”
- Proposed IAPS, “The Audit of Group Financial Statements”

In view of the significant number of changes made to the previous draft presented to the IAASB, the presentation and discussion of the revised proposed exposure draft will be based on the clean copy (Agenda Item 5-A).

Task Force Members

The Task Force comprises members of both the IAASB and the Auditing Practices Board of the United Kingdom and Ireland. The members of the Task Force are:

David Lindsell (Chair)	Former APB member
Arch Archambault	IAASB member
Denise Esdon	IAASB Vice Chair
Jon Grant	APB member and IAASB technical advisor
Diana Hillier	IAASB technical advisor
Graham Pimlott	APB member
Roberto Tizzano	IAASB member

Activities Since Last IAASB Discussions

The task Force met on July 14, 2004 to consider the comments it had received at the April and June meetings of the IAASB and make appropriate revisions to the proposed exposure draft of proposed revised ISA 320.

Significant Changes Made in Response to the IAASB's Comments

CONSIDERATION OF SPECIAL PURPOSE ENGAGEMENTS

The IAASB advised the Task Force that the revised ISA need not give detailed specific guidance in relation to special purpose engagements (which should instead be given in specific standards related to those other types of engagement), but could include a statement that the general principles apply equally to other types of engagement.

The proposed revised ISA is written to apply to the audit of a complete set of general purpose financial statements. The fact that the standards and guidance can also be applied to other types of engagement, such as the audit of special purpose financial statements, is indicated in footnote 1 to paragraph 1.

The IAASB asked the Task Force to consider whether the application of terms such as “the financial statements taken as a whole,” “complete set of financial statements” and “true and fair/present fairly” can be explained early in the document, making application of the document more generic.

The Task Force has reviewed the draft and changed the references to these terms where it considers it appropriate.

RELATIONSHIP BETWEEN MATERIALITY AND RISK

The IAASB advised the Task Force to draw upon the guidance in ISA 200 that deals with the relationship between materiality and risk, and also consider whether materiality need always be determined prior to risk assessment. The Task Force was also asked to specifically address the relationship between materiality and risk at the assertion level and tie this into the discussion of tolerable error.

ISA 200 does not actually provide guidance on the relationship between materiality and audit risk, it includes a statement that the relationship is addressed in ISA 320. However, the description of the relationship between materiality and audit risk has been revised and is now presented in paragraph 3. Reference is given to ISA 200. The guidance on “tolerable error” has also been revised (paragraphs 20 and 21).

The wording in the extant ISA 320 that refers to the “inverse relationship” between materiality and audit risk has not been included as the Task Force does not believe that it is helpful under the new audit risk model.

DEFINITION OF MATERIALITY

At the April 2004 IAASB meeting there was support for a suggestion that if the applicable financial reporting framework provides a definition of materiality, the auditor should be required to use that definition for audit purposes. A paper considering definitions of materiality that exist in different financial reporting frameworks was considered at the June 2004 IAASB meeting. The IAASB concluded that a reasonable position for the Task Force to adopt in the next draft to be presented to the IAASB for consideration was to use the IASB's definition of materiality in IAS 1.

The Task Force does not believe that the differences in wording of the various definitions of materiality that it identified in different financial reporting frameworks would make a necessary difference to the actual determination of materiality by auditors and concluded that, to avoid confusion, the revised ISA should establish a single definition of materiality for audit purposes. The Task Force believes that it would be appropriate to use the definition in IAS 1 but, however, to also indicate that if the applicable financial reporting framework uses a different definition of materiality the auditor considers whether that definition includes other factors that are relevant to the auditor's determination of materiality in the context of the audit (paragraph 7).

USERS

The IAASB advised the Task Force that the identification of “addressees of the auditor’s report” as being the “users” would not be appropriate for some jurisdictions. The Task Force was advised to consider the wording of the Assurance Framework, the ED of ISA 700 and the wording of the IASB Framework to see if more acceptable wording could be used to identify who “users” are for the purpose of determining materiality.

Paragraph 8 now states that “for the purpose of determining materiality in the audit of general purpose financial statements, the auditor forms a judgment as to the effect of misstatements on the economic decisions of the intended users for whom the auditor prepares the auditor’s report. The auditor considers the needs of those intended users as a group ...” (emphasis added). Use of the term “intended users” is consistent with the Assurance Framework. A statement is also made that “For a profit oriented entity, 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” which is consistent with guidance in the IASB Framework.

DISTINCTION BETWEEN PLANNING AND EVALUATION

The IAASB asked the Task Force to consider how the proposed revised ISA could clarify: (a) that consideration of misstatements of particular items of lesser amounts than the materiality level determined for the financial statements taken as a whole relates primarily to quantitative decisions taken when planning the audit and not to qualitative decisions taken into account at the evaluation stage; and (b) the distinction between these lesser “materiality” amounts and “tolerable error” determined to assess risks at the assertion level.

Paragraph 17 now makes clear that these are considerations made when establishing the overall strategy for the audit. A sentence has been added stating explicitly that such amounts are materiality levels (i.e. not levels of “tolerable error”). The guidance on tolerable error has been revised (paragraphs 20 and 21).

QUANTITATIVE GUIDELINES

As there is not necessarily a shared understanding of materiality across user groups, or indeed across auditors in different jurisdictions, the Task Force was asked to introduce quantitative guidelines/rules of thumb regarding materiality levels, as done in some national accounting and auditing standards.

The Task Force has added some guidance in paragraphs 12 and 13 on the use of percentages applied to benchmarks. This material draws on Canadian guidance and the experience of the Task Force members. The Task Force is concerned that the guidance should not be presented in a way that could lead to it being regarded as establishing rules for use in all circumstances.

TOLERABLE MISSTATEMENT/ERROR

While expressing some concern that “tolerable error” should not be read to imply that misstatements due to fraud should be excluded, nor that there is a level of error or fraud that should be tolerated, the IAASB expressed a preference for having one term (“tolerable error”) throughout the proposed revised ISA rather than having two terms (“tolerable error” and “tolerable misstatement”). The IAASB did not consider that there would be a difficulty in applying the term “tolerable error” more broadly than just to statistical tests.

The draft has been revised to refer only to “tolerable error” (paragraphs 20 and 21).

The IAASB concluded that the indication that tolerable error is “ordinarily” lower than materiality should be changed to indicate that it is always lower. A corresponding change should also be made to the guidance for groups as its retention would require an auditor who finds one error in one component of a group, to do additional work in all components, which is neither reasonable nor practical.

These changes have been made.

MISSTATEMENTS ARISING FROM DIFFERENCES OF JUDGMENT

The current classification of misstatements arising from differences of judgment as a distinct category from known misstatements and likely misstatements was queried, as it was felt to be more correctly a sub-category. The IAASB, however, acknowledged that distinguishing misstatements arising from differences in judgment from factual misstatements can be useful when communicating with those charged with governance. It was therefore agreed that the Task Force should reconsider how the categorization could be presented and also consider whether a different term could be used that would give more emphasis to the fact that these misstatements relate to the inherent imprecision in accounting estimates.

The categorization has been moved to paragraph 32, in the section on communications of misstatements to management. “Misstatements arising from differences of judgment” are now described as “misstatements involving subjective decisions” and shown as a sub category of “known misstatements”.

COMMUNICATIONS TO THOSE CHARGED WITH GOVERNANCE

The Task Force was asked to continue developing the section dealing with communication to those charged with governance, and to liaise with the Task Force addressing the revision of ISA 260 on communication with those charged with governance as appropriate to determine the ultimate content and disposition of the standards and guidance.

The Task Force has moved the paragraphs relating to communications with those charged with governance to an appendix as proposed conforming changes to ISA 260. The appropriateness of this depends on whether ISA 260 is ultimately revised to be a detailed or umbrella standard, and the timing of the publication of the exposure draft of the proposed revised ISA 260. The Materiality Task Force is liaising with the Communications Task Force on these matters.

REPRESENTATIONS

As the issue of who written representations should be obtained from will be considered in the project to revise ISA 580, the IAASB suggested that paragraphs addressing written representations should not be exposed in the proposed revised ISA 320 and that the Task Force should liaise with the Task Force revising ISA 580.

The paragraphs relating to management representations have been moved to an appendix as proposed conforming changes to ISA 580.

MANAGEMENT BIAS

The IAASB asked the Task Force to continue to liaise with the Accounting Estimates Task Force on the consideration of management bias, and how it may be measured and taken into account when evaluating the effect of misstatements.

Wording on management bias is being kept in line with that being developed by the Accounting Estimates Task Force. The two Task Forces are proceeding on the basis that, with respect to management bias, proposed revised ISA 540 will address measurement and proposed revised ISA 320 will address evaluation of the effect (paragraphs 40 and 41).

OTHER MATTERS

The IAASB noted that the paragraphs dealing with the “nature and causes of misstatements” do not exclusively relate to materiality; the Task Force was asked to consider whether this material is adequately covered elsewhere and, if so, whether it should be retained in the standard on materiality.

The Task Force reviewed the other ISAs and concluded that the description of the nature and causes of misstatements is not fully covered elsewhere; accordingly it proposes that paragraph 4 be retained. The Task Force has deleted the paragraph that related to the possibility of a true and fair override(although not expressed in those terms) as it believes this will be adequately addressed in the revised ISA 700.

The IAASB agreed that the auditor should ordinarily communicate the materiality level and related planning issues to those charged with governance, but explanatory guidance was needed indicating the circumstances when such communication may not be appropriate.

Changes to the proposed standards and guidance have been made in paragraphs 11a to 11c of the proposed conforming changes to ISA 260.

The IAASB concluded that the paragraphs dealing with the auditor's report and legal and regulatory reporting responsibilities should be deleted, but those dealing with documentation should be retained.

The relevant paragraphs have been deleted.
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Other Matters for the Attention of the IAASB

PUBLIC SECTOR PERSPECTIVE

Draft wording that is being developed by the PSC has been included.

COMMENTS OF THE SMP TASK FORCE

An earlier draft of the proposed revised ISA has been reviewed by the SMP Task Force. Their comments, and the responses to them by the Materiality Task Force, are given in Agenda Paper 5-C.

Material Presented

Agenda Paper 5-A (Pages 1719–1734)	Draft exposure draft - clean
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Agenda Paper 5-B (Pages 1735–1760)	Draft exposure draft - mark-up (showing changes from the draft presented at the April 2004 IAASB meeting)
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Agenda Paper 5-C (Pages 1761-1768)	Comments of the SMP Task Force
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Action Requested

The IAASB is asked to review and comment on the proposed exposure draft and proposed conforming amendments to ISAs 260 and 580 and proposed IAPS, “The Audit of Group Financial Statements,” to enable the Task Force to prepare a revised proposed exposure draft for approval for issue.