

PREPARED FOR ILLUSTRATIVE PURPOSES ONLY**TEXT IS THE ED-ISA 320 TEXT****NO CHANGES IN RESPONSE TO COMMENTS
HAVE BEEN PROCESSED ON THIS DRAFT****PROPOSED INTERNATIONAL STANDARD ON AUDITING 320
(REVISED)****MATERIALITY IN PLANNING AND PERFORMING AN AUDIT**

(Effective for audits of financial statements for periods beginning on or after [date])

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International Standard on Auditing (ISA) 320 (Revised), “Materiality in Planning and Performing an Audit,” should be read in the context of the “Preface to the International Standards on Quality Control, Auditing, Assurance and Related Services,” which sets out the application and authority of ISAs.

Note: The paragraphs numbers in this document relates to the paragraph numbers in the exposure draft.

Introduction

1. ~~The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on materiality and how it is used in the identification and evaluation of misstatements when performing an audit of financial statements.~~ The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the determination of materiality and its application in planning and performing an audit of financial statements. How materiality is used in evaluating misstatements identified when performing an audit of financial statements is addressed in ISA XXX, “The Identification and Evaluation of Misstatements.” The standards and guidance in the ISA are to be adapted for audits of historical financial information other than financial statements.
2. **The auditor should consider materiality when planning and performing the audit to reduce audit risk to an acceptably low level that is consistent with the objective of an audit.**
3. ISA 200, “Objective and General Principles Governing an Audit of Financial Statements,” requires the auditor to plan and perform the audit to reduce audit risk to an acceptably low level that is consistent with the objective of an audit. Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risk of material misstatement of the financial statements and the risk that the auditor will not detect such misstatement. ISA 315, “Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement,” requires the auditor to identify and assess the risks of material misstatement at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures. ISA 330, “The Auditor’s Procedures in Response to Assessed Risks,” requires the auditor to design and perform further audit procedures in response to assessed risks. To do so, the auditor considers materiality:
 - (a) When identifying and assessing the risks of material misstatement;
 - (b) When determining the nature, timing and extent of further audit procedures; and
 - (c) When evaluating the effect of identified uncorrected misstatements on the auditor’s report.

Materiality in the Context of an Audit

6. Materiality can be defined in the following terms:
 “Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.”¹

¹ As defined in International Accounting Standard (IAS) 1, “Presentation of Financial Statements.” In the ISAs, misstatements are considered to include omissions.

7. If the applicable financial reporting framework provides a different definition of materiality, the auditor uses that definition for the purpose of the audit.

Users

8. The evaluation of whether a misstatement could influence economic decisions of users, and so be material, involves consideration of the characteristics of those users. Users are assumed to:
 - (a) Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;
 - (b) Understand that financial statements are prepared and audited to levels of materiality and that there is a relationship between the level of materiality used and the cost and timing of the audit;
 - (c) Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and
 - (d) Make reasonable economic decisions on the basis of the information in the financial statements.

The determination of materiality, therefore, takes into account how users with such characteristics could reasonably be expected to be influenced in making economic decisions.

9. In an audit of general purpose financial statements, the auditor's judgment as to matters that are material to users of financial statements is based on consideration of the needs of users as a group; the auditor does not consider the possible effect of misstatements on specific individual users, whose needs may vary widely. The International Accounting Standards Board's "Framework for the Preparation and Presentation of Financial Statements" (the IASB's Framework) indicates 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. In the audit of such entities, therefore, the collective needs of investors as a group is an appropriate frame of reference when determining materiality.
10. When determining materiality in audits of financial statements or other historical financial information, prepared for a special purpose, the auditor considers the needs of specific users in the context of the objective of the engagement.

Determining Materiality for the Financial Statements as a Whole when Planning the Audit

11. **The auditor should determine a materiality level for the financial statements as a whole for the purpose of:**
 - (a) **Determining the extent and nature of risk assessment procedures;**
 - (b) **Identifying and assessing the risks of material misstatement; and**
 - (c) **Determining the nature, timing and extent of further audit procedures.**

12. The auditor determines a materiality level for the financial statements as a whole when establishing the overall audit strategy for the audit (see ISA 300 (Revised), “Planning an Audit of Financial Statements”). Determining a materiality level for the financial statements as a whole helps to guide the auditor’s judgments in identifying and assessing the risks of material misstatements and in planning the nature, timing and extent of further audit procedures. This materiality level does not, however, establish a threshold below which identified misstatements are always considered to be immaterial when evaluating those misstatements and their effect on the auditor’s report. As discussed in paragraph 37, the circumstances related to some identified misstatements may cause the auditor to evaluate them as material even if they are below the materiality level determined when establishing the overall audit strategy.

Use of Percentages of Benchmarks

13. The determination of what is material to the users is a matter of professional judgment. The auditor often applies a percentage to a chosen benchmark as a step in determining materiality for the financial statements as a whole. When identifying an appropriate benchmark, the auditor has regard to factors such as:

- The elements of the financial statements (e.g., assets, liabilities, equity, income and expenses) and the financial statement measures defined in the applicable financial reporting framework (e.g., financial position, financial performance and cash flows), or other specific requirements of that framework;
- Whether there are financial statement items on which, for the particular entity, users’ attention tends to be focused (e.g., for the purpose of evaluating financial performance);
- The nature of the entity and the industry in which it operates; and
- The size of the entity, nature of its ownership and the way it is financed.

Examples of benchmarks that might be appropriate, depending on the nature and circumstances of the entity, include total revenues, gross profit and other categories of reported income, such as profit before tax from continuing operations. Profit before tax from continuing operations may be a suitable benchmark for profit oriented entities but may not be an appropriate benchmark for the determination of materiality when, for example, the entity’s earnings are volatile, when the entity is a not-for-profit entity 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. For asset based entities (e.g., an investment fund) an appropriate benchmark might be net assets.

14. Illustrative examples of percentages applied to benchmarks that might be considered include the following:
 - For a profit oriented entity, five percent of profit before tax from continuing operations, or one half of one percent of total revenues.
 - For a not-for-profit entity, one half of one percent of total expenses or total revenues.
 - For an entity in the mutual fund industry, one half of one percent of net asset value.

The auditor may consider higher or lower percentages than those illustrated above to be appropriate.

15. When determining materiality, the auditor ordinarily considers prior periods' financial results and financial positions, the period-to-date financial results and financial position, and budgets or forecasts for the current period, taking account of significant changes in the entity's circumstances (e.g. a significant business acquisition) and relevant changes of conditions in the economy as a whole or the industry in which the entity operates. For example, when the auditor usually determines materiality for a particular entity based on a percentage of profit, circumstances that give rise to an exceptional decrease or increase in profit may lead the auditor to conclude that materiality is more appropriately determined using a normalized profit figure based on past results.
16. Materiality is determined without regard to the degree of inherent uncertainty associated with the measurement of particular items. For example, the fact that the financial statements include very large provisions with a high degree of estimation uncertainty (e.g., provisions for insurance claims in the case of an insurance company, oil rig decommissioning costs in the case of an oil company, or, more generally, legal claims against an entity) does not cause the auditor to determine the materiality level for the financial statements to be higher than for financial statements that do not include such inherent estimation uncertainties.

Materiality for Particular Items of Lesser Amounts than the Materiality Level Determined for the Financial Statements as a Whole

17. **When establishing the overall strategy for the audit, the auditor should consider whether, in the specific circumstances of the entity, misstatements of particular items of lesser amounts than the materiality level determined for the financial statements as a whole, if any, could, in the auditor's judgment, reasonably be expected to influence economic decisions of users taken on the basis of the financial statements.** Any such amounts determined represent lower materiality levels to be considered in relation to the particular items in the financial statements.
18. In making this judgment, the auditor considers factors such as the following:
 - Whether accounting standards, law or regulations affect users' expectations regarding the measurement or disclosure of certain items (e.g., related party transactions and the remuneration of management and those charged with governance).
 - The key disclosures in relation to the industry and the environment in which the entity operates (e.g., research and development costs for a pharmaceutical company).
 - Whether attention is focused on the financial performance of a particular business segment that is separately disclosed in the financial statements (e.g., for a newly acquired business).
19. Obtaining an understanding of the views and expectations of those charged with governance, and of management, may help the auditor judge whether, in the specific circumstances of the entity, misstatements of particular items of lesser amounts than the materiality level for the

financial statements as a whole, if any, could reasonably be considered material by the users of the financial statements.

Tolerable Error²

20. **The auditor should determine one or more levels of tolerable error for classes of transactions, account balances and disclosures.**
21. When assessing the risks of material misstatements and designing and performing further audit procedures to respond to the assessed risks, the auditor allows for the possibility that some misstatements of lesser amounts than the materiality levels determined in accordance with paragraphs 11 and 17 could, in the aggregate, result in a material misstatement of the financial statements. To do so, the auditor determines one or more levels of tolerable error. Such levels of tolerable error are lower than the materiality levels.

Considerations as the Audit Progresses

22. **The auditor should revise the materiality levels in the event of becoming aware of information during the audit that would have caused different levels to have been determined initially.**
23. The auditor's determination of materiality for the financial statements as a whole and for particular items at the time of establishing the overall audit strategy 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 further audit procedures. For example, the auditor may have based materiality on the anticipated period end financial results; if actual financial results are substantially different, the determination of materiality may also change.
24. If the auditor concludes that a lower materiality level than that initially determined is appropriate, the auditor reconsiders the related levels of tolerable error and appropriateness of the nature, timing and extent of audit procedures.

Communications with Those Charged with Governance

44. Standards and guidance regarding communications about materiality to those charged with governance are set out in ISA 260, "Communication of Audit Matters with Those Charged with governance."

Documentation

45. **The auditor should document:**
 - (a) **The levels of materiality and tolerable error, including any changes thereto, used in the audit and the basis on which those levels were determined;**

² "Tolerable error" is the maximum error in a population (e.g., the class of transactions or account balance) that the auditor is willing to accept.

Effective Date

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

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