SA 320*

Materiality in Planning and Performing an Audit

(Effective for audits of financial statements for periods beginning on or after April 1, 2010)

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Material Modifications to ISA 320, "Materiality in Planning and Performing an Audit"

Standard on Auditing (SA) 320, "Materiality in Planning and Performing an Audit" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the authority of SAs and SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing".

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* Published in August, 2009 issue of the Journal.

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements. SA 450[1], explains how materiality is applied in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements.

Materiality in the Context of an Audit

2. Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:

- Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;
- Judgments about materiality are made in the light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and
- Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group.[2] The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

3. Such a discussion, if present in the applicable financial reporting framework, provides a frame of reference to the auditor in determining materiality for the audit. If the applicable financial reporting framework does not include a discussion of the concept of materiality, the characteristics referred to in paragraph 2 provide the auditor with such a frame of reference.

4. The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information

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[1] SA 450, "Evaluation of Misstatements Identified during the Audit".

[2] For example, paragraph 10 of the "Framework for the Preparation and Presentation of Financial Statements," issued by the Institute of Chartered Accountants of India (ICAI) in July 2000, indicates for a profit-oriented entity that "as providers of risk capital to the enterprise, investor need more comprehensive information than other users. The provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy".

needs of users of the financial statements. In this context, it is reasonable for the auditor to assume that users:

(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, presented and audited to levels of materiality;

(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.

5. The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report. (Ref: Para. A1)

6. In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. These judgments provide a basis for:

(a) Determining the nature, timing and extent 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.

The materiality determined when planning the audit does not necessarily establish an amount below which uncorrected misstatements, individually or in aggregate, will always be evaluated as immaterial. The circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are below materiality. Although, it is not practicable to design audit procedures to detect misstatements that could be material solely because of their nature, the auditor considers not only the size but also the nature of uncorrected misstatements, and the particular circumstances of their occurrence, when evaluating their effect on the financial statements.[3]

Effective Date

7. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

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[3] SA 450, paragraph A16.

Objective

8. The objective of the auditor is to apply the concept of materiality appropriately in planning and performing the audit.

Definition

9. For purposes of the SAs, *performance materiality* means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.

Requirements

Determining Materiality and Performance Materiality when Planning the Audit

10. When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than the materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures. (Ref: Para. A2-A11)

11. The auditor shall determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures. (Ref: Para. A12)

Revision as the Audit Progresses

12. The auditor shall revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially. (Ref: Para. A13)

13. If the auditor concludes that a lower materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise

performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate.

Documentation

14. The audit documentation shall include the following amounts and the factors considered in their determination:

(a) Materiality for the financial statements as a whole (see paragraph 10);

(b) If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures (see paragraph 10);

(c) Performance materiality (see paragraph 11); and

(d) Any revision of (a)-(c) as the audit progressed (see paragraphs 12-13).

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Application and Other Explanatory Material

Materiality and Audit Risk (Ref: Para. 5)

A1. In conducting an audit of financial statements, the overall objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and to report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.[4] The auditor obtains reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level[5]. 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 risks of material misstatement and detection risk[6]. Materiality and audit risk are considered throughout the audit, in particular, when:

(a) Identifying and assessing the risks of material misstatement[7];

(b) Determining the nature, timing and extent of further audit procedures[8]; and

(c) Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report[9].

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[4] SA 200, paragraph 11.
[5] SA 200, paragraph 17.
[6] SA 200, paragraph 13(c).
[7] SA 315, "Identifying and Assessing the Risks of Material Misstatements Through Understanding the Entity and Its Environment".
[8] SA 330, "The Auditor's Responses to Assessed Risks".
[9] SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements".

Determining Materiality and Performance Materiality when Planning the Audit (Ref: Para. 10)

Use of Benchmarks in Determining Materiality for the Financial Statements as a Whole

A2. Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following:

- The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);
- Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);
- The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates;
- The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and
- The relative volatility of the benchmark.

A3. Examples of benchmarks that may be appropriate, depending on the circumstances of the entity, include categories of reported income such as profit before tax, total revenue, gross profit and total expenses, total equity or net asset value. Profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues.

A4. In relation to the chosen benchmark, relevant financial data ordinarily includes prior periods' financial results and financial positions, the period-to-date financial results and financial position, and budgets or forecasts for the current period, adjusted for significant changes in the circumstances of the entity (for example, a significant business acquisition) and relevant changes of conditions in the industry or economic environment in which the entity operates. For example, when, as a starting point, the materiality for the financial statements as a whole is determined for a particular entity based on a percentage of profit before tax from continuing operations, circumstances that give rise to an exceptional decrease or increase in such profit may lead the auditor to conclude

that the materiality for the financial statements as a whole is more appropriately determined using a normalized profit before tax from continuing operations figure based on past results.

A5. Materiality relates to the financial statements on which the auditor is reporting. Where the financial statements are prepared for a financial reporting period of more or less than twelve months, such as may be the case for a new entity or a change in the financial reporting period, materiality relates to the financial statements prepared for that financial reporting period.

A6. Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment. There is a relationship between the percentage and the chosen benchmark, such that a percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue. For example, the auditor may consider five percent of profit before tax from continuing operations to be appropriate for a profit oriented entity in a manufacturing industry, while the auditor may consider one percent of total revenue or total expenses to be appropriate for a not-for-profit entity. Higher or lower percentages, however, may be deemed appropriate in different circumstances.

Considerations Specific to Small Entities

A7. When an entity's profit before tax from continuing operations is consistently nominal, as might be the case for an owner-managed business where the owner takes much of the profit before tax in the form of remuneration, a benchmark such as profit before remuneration and tax may be more relevant.

A8. In the case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), legislators and regulators are often the primary users of its financial statements. Furthermore, the financial statements may be used to make decisions other than economic decisions. The determination of materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) in an audit of the financial statements of those entities may therefore be influenced by legislative and regulatory requirements, and by the financial information needs of legislators and the public in relation to public utility programs/projects, such as, Accelerated Irrigation Benefit Programme (AIBP), Pradhan Mantri Gram Sadak Yojana (PMGSY) undertaken by the Central/State governments or related government entities .

A9. In an audit of the entities doing public utility programs/projects, total cost or net cost (expenses less revenues or expenditure less receipts) may be

appropriate benchmarks for that particular program/project activity. Where an entity has custody of the assets, assets may be an appropriate benchmark.

Materiality Level or Levels for Particular Classes of Transactions, Account Balances or Disclosures (Ref: Para. 10)

A10. Factors that may indicate the existence of one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements include the following:

- Whether law, regulations or the applicable financial reporting framework affect users' expectations regarding the measurement or disclosure of certain items (for example, related party transactions, and the remuneration of management and those charged with governance).
- The key disclosures in relation to the industry in which the entity operates (for example, research and development costs for a pharmaceutical company).
- Whether attention is focused on a particular aspect of the entity's business that is separately disclosed in the financial statements (for example, a newly acquired business).

A11. In considering whether, in the specific circumstances of the entity, such classes of transactions, account balances or disclosures exist, the auditor may find it useful to obtain an understanding of the views and expectations of those charged with governance and management.

Performance Materiality (Ref: Para. 11)

A12. Planning the audit solely to detect individually material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated, and leaves no margin for possible undetected misstatements. Performance materiality (which, as defined, is one or more amounts) is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole. Similarly, performance materiality relating to a materiality level determined for a particular class of transactions, account balance or disclosure is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in that particular class of transactions, account balance or disclosure exceeds the materiality level for that particular class of transactions, account balance or disclosure. The determination

of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by the auditor's understanding of the entity, updated during the performance of the risk assessment procedures; and the nature and extent of misstatements identified in previous audits and thereby the auditor's expectations in relation to misstatements in the current period.

Revision as the Audit Progresses (Ref: Para. 12)

A13. Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) may need to be revised as a result of a change in circumstances that occurred during the audit (for example, a decision to dispose of a major part of the entity's business), new information, or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures. For example, if during the audit it appears as though actual financial results are likely to be substantially different from the anticipated period end financial results that were used initially to determine materiality for the financial statements as a whole, the auditor revises that materiality.

Material Modifications to ISA 320, "Materiality in Planning and Performing an Audit"

Deletions

1. Paragraph A3 of ISA 320 (A8 of SA 320) dealt with the determination of materiality for the financial statements as a whole or for particular assertion in an audit of financial statements of a public sector entity, which is influenced by legislative and regulatory requirements, and by the financial information needs of legislators and the public in relation to public sector programs. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such a specific situation may exist in case of Central/State governments or related government entities, or programs/projects launched by them, pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of Paragraph A3 in ISA, highlighting such fact, has been retained and the paragraph has been re-numbered as A8.

2. Paragraph A10 of ISA 320(A9 of SA 320) states that in an audit of the public sector entities, total cost or net cost (expenses less revenues or expenditure less receipts) may be appropriate benchmarks for program/project activities. Where a public sector entity has custody of assets, assets may be an appropriate benchmark. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such a specific situation may exist in case of Central/State governments or related government entities, or programs/projects launched by them, pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of Paragraph A10 in ISA, highlighting such fact, has been retained.