

**PROPOSED STATEMENT ON AUDITING STANDARDS, MATERIALITY IN
PLANNING AND PERFORMING AN AUDIT (REDRAFTED)**

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Proposed SAS, *Materiality in Planning and Performing an Audit* (Redrafted)

Introduction

Scope of This Statement on Auditing Standards

1. This Statement on Auditing Standards (SAS) addresses the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements. Proposed SAS, *Evaluation of Misstatements Identified During the Audit*, 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 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. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

3. Such a discussion 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 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: par. 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.
- 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 the 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.¹

Effective Date

7. This SAS is effective for audits of financial statements for periods beginning on or after December 15, 2010.²

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 generally accepted auditing standards, *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.

¹ Proposed SAS, *Evaluation of Misstatements Identified During the Audit*, paragraph A16.

² This date is provisional but will not be earlier than December 15, 2010.

Requirements

Determining Materiality and Performance Materiality When Planning the Audit

10. When establishing the overall audit strategy, the auditor should determine materiality for the financial statements as a whole. If, in the specific circumstances of the entity, one or more particular classes of transactions, account balances, or disclosures exist 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, then, taken on the basis of the financial statements, the auditor should also determine the materiality level or levels to be applied to those particular classes of transactions, account balances, or disclosures. (Ref: par. A2–A13)

11. The auditor should determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing, and extent of further audit procedures. (Ref: par. A14)

Revision as the Audit Progresses

12. The auditor should 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: par. A15–A16)

13. If the auditor concludes that a lower materiality than that initially determined for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances, or disclosures) is appropriate, the auditor should 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 should 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)
- d. Any revision of *a–c* as the audit progressed (see paragraphs 12–13)

Application and Other Explanatory Material

Materiality and Audit Risk (Ref: par. 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 generally accepted auditing standards in accordance with the auditor's findings.³ The auditor obtains reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level.⁴ 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.⁵ Materiality and audit risk are considered throughout the audit, in particular, when

- identifying and assessing the risks of material misstatement;⁶
- determining the nature, timing, and extent of further audit procedures;⁷ and
- evaluating the effect of uncorrected misstatements, if any, on the financial statements⁸ and in forming the opinion in the auditor's report.⁹

Determining Materiality and Performance Materiality when Planning the Audit

Considerations Specific to Governmental Entities (Ref: par. 10)

A2. In the case of a governmental entity, 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 a governmental entity is, therefore, influenced by legislative and regulatory requirements.

A3. For most state or local governments, a governmental entity's applicable financial reporting framework is based on multiple reporting units. That is, a state or local governmental entity's applicable financial reporting framework requires the presentation of financial statements for its varied activities in various reporting units, its business-type activities, and each of its major governmental and enterprise funds. Consequently, a reporting unit, or aggregation of reporting units, of the governmental entity represents an opinion unit to the auditor. In this context, the auditor is responsible for the detection of misstatements

³ Proposed SAS, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards*, paragraph 11.

⁴ Proposed SAS, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards*, paragraph 17.

⁵ Proposed SAS, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards*, paragraph 13(c).

⁶ Proposed SAS, *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement* (Redrafted).

⁷ Proposed SAS, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (Redrafted).

⁸ Proposed SAS, *Evaluation of Misstatements Identified During the Audit*, paragraph 11.

⁹ This requirement and the related guidance are expected to be included in AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standard*, vol. 1), when AU section 508 is redrafted for clarity and convergence with ISA No. 700, *The Independent Auditor's Report on General Purpose Financial Statements*, as part of the Auditing Standards Board's Clarification and Convergence project.

that are material to an opinion unit within a governmental entity, but is not responsible for the detection of misstatements that are not material to an opinion unit.

Use of Benchmarks in Determining Materiality (Ref: par. 10)

A4. 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 items exist 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 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)
- The relative volatility of the benchmark

A5. 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.

A6. 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; 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, 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 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.

A7. Materiality is determined based on the auditor's understanding of the user needs and expectations. User expectations may differ based on the degree of inherent uncertainty associated with the measurement of particular items in the financial statements, among other considerations. For example, the fact that the financial statements include very large provisions with a high degree of estimation uncertainty (for example, 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) may influence the user's assessment of materiality. However, according to paragraph 10 of the proposed SAS, *Evaluation of Misstatements Identified During the Audit*, for audit purposes, after materiality is established, the auditor is required to evaluate misstatements, if any, regardless of the degree of inherent uncertainty associated with the measurement of particular items in the financial statements.

A8. Materiality relates to the financial statements being audited on which the auditor is reporting. Where the financial statements are prepared for a financial reporting period of more or less than 12 months, such 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.

A9. Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment. A relationship exists 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 a percentage of profit before tax from continuing operations to be appropriate for a profit-oriented entity in a manufacturing industry, whereas the auditor may consider a different percentage of total revenue or total expenses to be appropriate for a not-for-profit entity.

Considerations Specific to Small, Less Complex Entities

A10. When an entity's profit before tax from continuing operations is consistently nominal, which 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.

Considerations Specific to Governmental Entities

A11. In an audit of a governmental entity, total cost or net cost (expenses less revenues or expenditure less receipts) may be appropriate benchmarks for program activities. Where a governmental entity has custody of public assets, assets may be an appropriate benchmark.

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

A12. 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)

A13. 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: par. 11)

A14. Planning the audit solely to detect individual 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: par. 12)

A15. In some situations, the auditor may determine materiality for planning purposes before the financial statements to be audited are prepared. In those situations, the auditor's judgment about materiality might be based on the entity's annualized interim financial statements or financial statements of one or more prior annual periods, as long as recognition is given to the effects of major changes in the entity's circumstances (for example, a significant merger) and relevant changes in the economy as a whole or the industry in which the entity operates.

A16. 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.