

INTERNATIONAL STANDARD ON AUDITING 320

AUDIT MATERIALITY

(Effective for audits of financial statements for periods
beginning on or after December 15, 2004)*

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International Standard on Auditing (ISA) 320, "Audit Materiality" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISAs.

* ISA 240, "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements," ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," ISA 330, "The Auditor's Procedures in Response to Assessed Risks," and ISA 500, "Audit Evidence" gave rise to conforming amendments to ISA 320. The conforming amendments are effective for audits of financial statements for periods beginning on or after December 15, 2004 and have been incorporated in the text of ISA 320.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the concept of materiality and its relationship with audit risk.
2. **The auditor should consider materiality and its relationship with audit risk when conducting an audit.**
3. “Materiality” is defined in the International Accounting Standards Board’s “Framework for the Preparation and Presentation of Financial Statements” in the following terms:

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.

Materiality

4. **The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.** The assessment of what is material is a matter of professional judgment.
5. In designing the audit plan, the auditor establishes an acceptable materiality level so as to detect quantitatively material misstatements. However, both the amount (quantity) and nature (quality) of misstatements need to be considered. Examples of qualitative misstatements would be the inadequate or improper description of an accounting policy when it is likely that a user of the financial statements would be misled by the description, and failure to disclose the breach of regulatory requirements when it is likely that the consequent imposition of regulatory restrictions will significantly impair operating capability.
6. The auditor needs to consider the possibility of misstatements of relatively small amounts that, cumulatively, could have a material effect on the financial statements. For example, an error in a month end procedure could be an indication of a potential material misstatement if that error is repeated each month.
7. The auditor considers materiality at both the overall financial statement level and in relation to classes of transactions, account balances, and disclosures. Materiality may be influenced by considerations such as legal and regulatory requirements and considerations relating to classes of transactions, account

balances, and disclosures and their relationships. This process may result in different materiality levels depending on the aspect of the financial statements being considered.

8. **Materiality should be considered by the auditor when:**
 - (a) **Determining the nature, timing and extent of audit procedures; and**
 - (b) **Evaluating the effect of misstatements.**

The Relationship Between Materiality and Audit Risk

9. When planning the audit, the auditor considers what would make the financial statements materially misstated. The auditor's understanding of the entity and its environment establishes a frame of reference within which the auditor plans the audit and exercises professional judgment about assessing the risks of material misstatement of the financial statements and responding to those risks throughout the audit. It also assists the auditor to establish materiality and in evaluating whether the judgment about materiality remains appropriate as the audit progresses. The auditor's assessment of materiality, related to classes of transactions, account balances, and disclosures, helps the auditor decide such questions as what items to examine and whether to use sampling and substantive analytical procedures. This enables the auditor to select audit procedures that, in combination, can be expected to reduce audit risk to an acceptably low level.
10. There is an inverse relationship between materiality and the level of audit risk, that is, the higher the materiality level, the lower the audit risk and vice versa. The auditor takes the inverse relationship between materiality and audit risk into account when determining the nature, timing and extent of audit procedures. For example, if, after planning for specific audit procedures, the auditor determines that the acceptable materiality level is lower, audit risk is increased. The auditor would compensate for this by either:
 - (a) Reducing the assessed risk of material misstatement, where this is possible, and supporting the reduced level by carrying out extended or additional tests of control; or
 - (b) Reducing detection risk by modifying the nature, timing and extent of planned substantive procedures.

Materiality and Audit Risk in Evaluating Audit Evidence

11. The auditor's assessment of materiality and audit risk may be different at the time of initially planning the engagement from at the time of evaluating the results of audit procedures. This could be because of a change in circumstances or because of a change in the auditor's knowledge as a result of performing audit procedures. For example, if audit procedures are performed prior to

period end, the auditor will anticipate the results of operations and the financial position. If actual results of operations and financial position are substantially different, the assessment of materiality and audit risk may also change. Additionally, the auditor may, in planning the audit work, intentionally set the acceptable materiality level at a lower level than is intended to be used to evaluate the results of the audit. This may be done to reduce the likelihood of undiscovered misstatements and to provide the auditor with a margin of safety when evaluating the effect of misstatements discovered during the audit.

Evaluating the Effect of Misstatements

12. **In evaluating whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework, the auditor should assess whether the aggregate of uncorrected misstatements that have been identified during the audit is material.**
13. The aggregate of uncorrected misstatements comprises:
 - (a) Specific misstatements identified by the auditor including the net effect of uncorrected misstatements identified during the audit of previous periods; and
 - (b) The auditor's best estimate of other misstatements which cannot be specifically identified (i.e., projected errors).
14. The auditor needs to consider whether the aggregate of uncorrected misstatements is material. If the auditor concludes that the misstatements may be material, the auditor needs to consider reducing audit risk by extending audit procedures or requesting management to adjust the financial statements. In any event, management may want to adjust the financial statements for the misstatements identified.
15. **If management refuses to adjust the financial statements and the results of extended audit procedures do not enable the auditor to conclude that the aggregate of uncorrected misstatements is not material, the auditor should consider the appropriate modification to the auditor's report in accordance with ISA 701, "Modifications to the Independent Auditor's Report."**
16. If the aggregate of the uncorrected misstatements that the auditor has identified approaches the materiality level, the auditor would consider whether it is likely that undetected misstatements, when taken with aggregate uncorrected misstatements could exceed materiality level. Thus, as aggregate uncorrected misstatements approach the materiality level the auditor would consider reducing audit risk by performing additional audit procedures or by requesting management to adjust the financial statements for identified misstatements.

Communication of Errors

17. **If the auditor has identified a material misstatement resulting from error, the auditor should communicate the misstatement to the appropriate level of management on a timely basis, and consider the need to report it to those charged with governance in accordance with ISA 260, “Communication of Audit Matters with Those Charged with Governance.”**

Public Sector Perspective

1. *In assessing materiality, the public sector auditor must, in addition to exercising professional judgment, consider any legislation or regulation which may impact that assessment. In the public sector, materiality is also based on the “context and nature” of an item and includes, for example, sensitivity as well as value. Sensitivity covers a variety of matters such as compliance with authorities, legislative concern or public interest.*