**ISA 320 "Materiality in the Identification and Evaluation of Misstatements"**

**Comments from a SMP perspective**

**[*Note to the IAASB: These comments from the SMP Task Force were received in March and refer to the draft that was being developed for presentation to the April 2004 meeting of the IAASB. The italic annotations explain how the points are addressed in the current draft.*]**

**General**

1. The financial reports for small entities tend not to be so widely distributed so it is often much easier to identify users and their specific user needs. There is also a better understanding of the nature of probable / possible economic decisions and the ability to identify conflict of interest situations that may arise between stakeholders (all of which can then be addressed in the audit approach).

2.The document contains no specific material on the impact of differences between SMEs and others. It does not seem to have drawn on the extant material in IAPS 1005.

[***The Task Force has previously concluded that it considers that the principles set out on the proposed revised ISA apply equally to entities of all types. Paragraph 12, which gives examples of benchmarks, makes specific reference to owner managed businesses.***

***The extant material in IAPS 1005 is attached to this paper for reference. It does not include significant guidance that is not covered by the proposed revised ISA, taking account of the changes to the standards and guidance that the Materiality Task Force is proposing:***

***Paragraph 47of the IAPS gives the definition of materiality as set out in the extant ISA 320. The Materiality Task Force is proposing a new definition.***

***Paragraphs 48 to 50 of the IAPS (re "Planning Stage") focus on a formulaic, percentage based approach to setting materially. For the draft presented to the April 2004 meeting of the IAASB, this was an approach that the Materiality Task Force did not wish to adopt. However, at the April 2004 meeting, the Task Force was asked to introduce quantitative guidelines/rules of thumb regarding materiality levels and has done so (paragraphs 12 and 13).***

***Paragraphs 48 and 50 of the IAPS relate to the benchmarks that may be used. Guidance in this area for entities of all sizes is given in paragraphs 12 to 14 of the proposed revised ISA. Paragraph 49 of the IAPS discusses the situation where draft financial statements are not available and suggests, for example, using a trial balance or prior period financial statements. The Materiality Task Force believes that the indication in paragraph 14 of the proposed revised ISA that the auditor ordinarily considers prior period results, budgets and forecast for the current period etc., is adequate.***

***Paragraphs 51 to 53 of the IAPS address the assessment of materiality when evaluating results of audit procedures. The Task Force believes this guidance is adequately covered in the proposed revised ISA. Paragraph 22 of the proposed revised ISA requires the auditor to revise the materiality levels in the event of becoming aware of information that would have caused different materiality levels to be determined initially (this should cover the guidance in paragraph 51 of the IAPS). The proposed revised ISA generally puts a lot of emphasis on qualitative considerations, which should cover paragraphs 52 and 53 of the IAPS (in particular paragraphs 11 and 27 of the proposed revised ISA address similar points).***]

3. The document should consider conformity with ISAE 3000. ISAE 3000 makes the point that '*Considering materiality requires the practitioner to understand and assess what factors might influence the decisions of the intended users'*

[***ISAE 3000 addresses "Assurance Engagements <u>Other Than</u> Audits or Reviews of Historical Financial Information". However, paragraph 8 of the proposed revised ISA states that "For the purpose of determining materiality in the audit of general purpose financial statements, the auditor forms a judgment of the effect of misstatements on the economic decisions of the intended users for whom the auditor prepares the auditor's report" (It should be noted that the draft presented to IAASB in July 2003 was more specific in this area and the Task Force was asked to tone the guidance down to avoid giving rise to an expectation that auditors would take account of the specific needs of all specific users). Paragraphs 12 and 18 of the proposed revised ISA give examples of factors might influence decisions of users.***]

**Paragraph 5**

Line 5: is it necessary to qualify 'users' …'who have a reasonable understanding of business, economic activities and financial reporting.' There is arguably a reasonable expectation that users will understand the business and economic activities but there is a question hanging over the extent to which they understand financial reporting. This is particularly the case with the user of the financial reports of SMEs.

[***This comment relates to the wording of the definition of materiality that was given in the draft presented to the April 2004 meeting of the IAASB. The definition has now been revised and no longer includes those words. However, paragraph 9(a) of the current draft does state that "[users are assumed to] have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence." This wording is taken from paragraph 25 of the IASB "Framework for the Preparation and Presentation of Financial Statements," which is also referred to in the recently revised IAS 1 "Presentation of Financial Statements". The Task Force agrees that there is a question over the level of understanding of some users, and not just of financial reports of SMEs. However, the Task Force believes that it is necessary to set out this assumption, and the others given in paragraph 9, to avoid a risk that the auditor could be expected to set materiality levels that are so low that the cost of the audit outweighs the benefit, particularly for the audit of general purpose financial statements (e.g. because users who do not understand the basis on which the financial statements are prepared may have unreasonable expectations as to the accuracy of the financial statements).***

**Paragraph 7**

Following the point made in Paragraph 5 above the assumptions made about users here are likely only to be appropriate to those users in the capital markets. However, there would be an expectation on all users to be aware of the significance of the audit.

[***See comments above re paragraph 5. The Task Force believes the assumptions to be reasonable for all types of entity.***]

**Paragraph 15**

Bullet point 2: In the case of SMEs the items are often likely to have equal weighting or a number of items may be equally weighted.

[***Paragraph 15 is now paragraph 12. The bullet point has been reworded and now indicates that the auditor has regard to "whether there are financial statement items on which … users' attention tends to be focused…"***]

**Paragraph 17**

Bullet point 2: Insert after 'industry' - 'and the environment..'.

**[*Paragraph 17 is now paragraph 18. This change has been made.*]**

**Paragraph 28 / 29**

In owner-managed businesses the concept of governance is very likely to be different from that of a quoted company. This paragraph, therefore, is inappropriate to many situations in the audit of SMEs.

We have reservations regarding communication of materiality levels selected for the audit and the basis for that determination. This communication is likely to create an expectation gap if the audit process is not properly understood by those charged with governance.

In the case of SMEs it is quite likely that a misunderstanding of the nature of our audit procedures could arise. Even though paragraph 29 refers to this discussion as part of the 'broader communication of the general approach…' the significance of materiality levels thus communicated are likely to be misunderstood without a prerequisite appreciation of the risk assessment process, sample testing, evaluation etc.

Also, it is not clear at what stage of the audit this information should be communicated.

For SMEs, those charged with governance are usually the same people as those with responsibility for preparation of the financial report (and day-to-day operations). The risk is that amounts below a communicated materiality level will not be given due attention/appropriate control by management when there is pressure to complete the financial report.

**[*These comments relate to the paragraphs that address the communication of materiality levels to those charged with governance. These are now presented as suggested conforming changes to ISA 260 (paragraphs 11a to 11c in the appendix to the proposed revised ISA 320). The requirement has been modified to indicate that such communication is not made if the auditor believes that it would influence management's approach to the preparation of the financial statements (e.g. by resulting in management being less attentive to the detection and correction of misstatements). Such considerations are relevant to entities of all sizes, not just SMEs.***

**Paragraph 35 to 39**

Once again there may be problems due to the conceptual differences between governance of quoted companies as compared to SMEs. It may therefore be appropriate to insert ' …to those charged with governance when appropriate.'

[***These comments relate to the paragraphs that address the communication of uncorrected misstatements to those charged with governance. These are now presented as suggested conforming changes to ISA 260 (paragraphs 11d to 11h in the appendix to the proposed revised ISA 320). The words "unless they are the same persons as management (as may be the case in smaller entities)" has been added after "to those charged with governance".***]

For SMEs, misstatements may also be indicative of inadequate books and records and impact on legislative obligations.

[***This consideration applies to entities of all sizes. The last sentence of paragraph 26 in the current draft states that "The auditor also considers whether the misstatements reflect on the adequacy of the financial records maintained by the entity, or are indicative of internal control weaknesses, and the implications thereof for the auditor's reporting responsibilities." This wording was included in the draft presented to the April 2004 meeting, although in a different position.***]

## Issue in the Agenda Covering Paper

In relation to OBTAINING REPRESENTATIONS FROM THOSE RESPONSIBLE FOR APPROVING THE FINANCIAL STATEMENTS, the Task Force mentioned their July 2003 letter concerning the difficulties experienced over the terms management and those charged with governance.

A continuing problem affecting SME audits is that the two terms (now 3 as the term '*those who are responsible for approving the issuance of the financial statements*' has also been coined) generally refer to the same individuals. ISA 260 makes no allowance for auditors to take into account, in determining whether communication should take place, whether the individuals already know the matter which is to be the subject of the communication.

Where a matter is required to be communicated to both management and those charged with governance and the terms refer to the same individuals, clearly only one physical communication is required. Where however the subject matter is different there are difficulties. The ED requires auditors to communicate to those charged with governance (paragraph 35) *'misstatements that management declines to correct, other than those that the auditor believes are clearly trivial'.* Even though in an SME, the recipient(s) of this communication may comprise management and already know what is to be communicated – the auditor has to make this communication or breach the standard.

[***These comments relate to a specific issue that was highlighted in the Covering Paper presented to the April 2004 meeting. See the comments above in relation to paragraph 35. The proposed text has been changed to make clear that the communication need not be made if those charged with governance are the same persons as management.***]

# Extract from IAPS 1005

**ISA 320: Audit Materiality**

47. “Materiality” is defined in the International Accounting Standards Board’s “Framework for the Preparation and Presentation of Financial Statements” as follows: “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.”

**Planning Stage**

48. For audit planning purposes, it is generally necessary to assess materiality from a qualitative and quantitative perspective. One purpose of this preliminary judgment about materiality is to focus the auditor’s attention on the more significant financial statement items while determining the audit strategy. As there are no authoritative pronouncements on how materiality is assessed in quantitative terms, the auditor in each case applies professional judgment in the light of the circumstances. One approach to the assessment of quantitative materiality is to use a percentage of a key figure in the financial statements such as one of the following:

    - Profit or loss before tax (adjusted, if appropriate, for the effect of any abnormal levels of items of expenditure such as the owner-manager’s remuneration).
    - Revenue.
    - Balance sheet total.

49. Often in the case of small entities, draft financial statements are not available to the auditor at the commencement of the audit. When this is the case, the auditor uses the best information available at the time. The current year’s trial balance may be used, if available. Often an estimate of revenue for the current period can be more readily obtained than of profit (or loss) or of a balance sheet total. A common approach in the preliminary judgment of materiality is to calculate materiality on the previous year’s audited financial statements as amended for known circumstances in relation to the year subject to audit.

50. Assessing materiality as a percentage of pre-tax results may be inappropriate when the entity is at or near the break-even point as it may give an inappropriately low level of materiality, leading to unnecessarily extensive audit procedures. In such cases, the auditor may apply the percentage method, for example, to revenue or balance sheet totals. Alternatively, materiality may be assessed having regard to assessed levels of materiality in prior years and the normal level of results. In addition to considering materiality at the overall financial statement level, the auditor considers materiality in relation to individual account balances, classes of transactions, and disclosures.

**Assessment of Materiality When Evaluating the Results of Audit Procedures**

51. Whatever basis may be used to assess materiality for audit planning purposes, the auditor reassesses materiality when evaluating the results of audit procedures. This reassessment takes account of the final version of the draft financial statements, incorporating all agreed adjustments and information obtained during the course of the audit.

52. Although materiality at the reporting stage is considered in quantitative terms, there is no clear threshold value but rather a range of values within which the auditor exercises judgment. Amounts above the upper limit of the range may be presumed material and amounts below the lower limit may be presumed not material, although either presumption may be rebutted by applying qualitative considerations.

53. In addition, although planning may have been based on a quantitative assessment of materiality, the auditor's opinion will take into account not only the amount but also the qualitative nature of unadjusted misstatements within the financial statements.

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