Standards on Auditing

SA 320 (Revised) Materiality in Planning and Performing an Audit

Scope: SA 320 deals with the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements

Objective: Auditor to apply the concept of materiality appropriately in planning and performing the audit.

Materiality in the Context of an Audit:

- 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. Auditor uses materiality when planning and performing an audit to reduce audit risk to an acceptably low level that is consistent with the objective of an audit. It is one of the key judgments on the audit, This judgment provide a basis for:

- Determining the nature, timing and extent of risk assessment procedures;
- Identifying and assessing the risks of material misstatement; and
- Determining the nature, timing and extent of further audit procedures

Materiality, from an entity's point of view:

- is the threshold at which the subject matter information becomes important enough to be reported
- includes consideration of whether the reported subject matter information is free from misstatements that would affect the decisions of users taken on the basis of that information.

Materiality, from auditors' perspective, helps us to:

- determine the nature, timing and extent of our evidence gathering procedures
- evaluate whether the subject matter information is free from misstatement.

Materiality from the user's perspective:

A misstatement or the aggregate effect of misstatements is material when, in the context of the surrounding circumstances, it is probable that the decision of a user who is relying on the reported subject matter information and who has a reasonable knowledge of entity and its activities, would be changed or influenced by such misstatement or the aggregate effect.

Materiality for the financial statements as a whole (OM) and performance materiality (PM)

- Materiality
  - Materiality for financial statement as a whole (OM)
    - When establishing the overall audit strategy, the auditor shall determine OM.
    - Materiality for particular class of transactions, account balances or disclosures
      - Auditor to determine separate materiality if misstatements of lesser amount than OM could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements
  - Performance materiality (PM)
    - Amounts set by the auditor at less than OM to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds OM
    - PM 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.

Determining materiality for the financial statements as a whole and performance materiality

- 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.
- Examples of benchmarks that may be appropriate, depending on the circumstances of the entity, include:
  - Profit before tax
  - total revenue
  - gross profit
  - total expenses
  - total equity or net asset value etc.

Factors that may affect the identification of an appropriate benchmark include the following:

- The elements of the financial statements
- Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused
- 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
- The relative volatility of the benchmark

Scenario:

- 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

Factors that may affect the percentage to be applied to a chosen benchmark include the following:

- Determining a percentage to be applied 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. 5% of PBT vis-à-vis 1% of total revenue or expenses.

Considerations when selecting benchmarks

Scenario	Benchmark
Profit before tax is nominal	Profit before tax and remuneration
Entities doing public utility programs/projects	Total Cost or Expenses Less Revenues
Current Year Profits are Low	Average of the Past three years
Profit oriented entity with break-even results	Revenue
Private Equity Firm primary focus on EBITDA	EBIDTA
Production Costs recharged to Group	Production Costs
Mutual Funds	Net Assets

Materiality Level or Levels for Particular Classes of Transactions, Account Balances or Disclosures

Some of the factors to consider:

1. 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).
2. The key disclosures in relation to the industry in which the entity operates (for example, research and development costs for a pharmaceutical company).
3. 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).

Revision as the Audit Progresses: The auditor shall revisit and if needed revise materiality in the event of becoming aware of new information or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures

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

- Materiality for the financial statements as a whole
- If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures
- Performance materiality and
- Any revision of above as the audit progressed

Thank you