Audit Materiality

ISA 320

Materiality in Planning and Performing an Audit

Lebanese Association of Certified Public Accountants - LACPA

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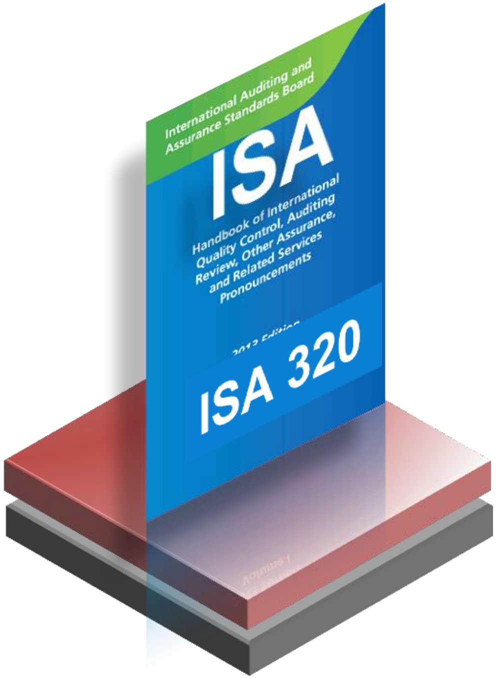
March 23, 2016



ISA 320

Materiality in Planning and Performing an Audit

Paragraphs: 14 Paragraph, 13A Application

Effective Date: effective for audits of financial statements for periods beginning on or after December 15, 2009.

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

Opinion

We have audited the financial statements of (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Responsibilities of Management and Those Charged with Governance for the F/S

Management is responsible for the preparation and fair presentation of the financial statements in accordance with IFRSs, and for such internal control as management determines is necessary to enable **the preparation of the financial statements that are free from material misstatement, whether due to fraud or error.**

In preparing the financial statements , management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

TCWG are responsible for overseeing the Company's financial reporting process.

Auditor's Responsibilities for the Audit of the F/S

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

[Date
[Auditor Signature and Address]

NEW

Determining and Using Materiality

According to Clarity ISA project of 2009, an outcome of the revision of ISA 320 was **two separate ISAs** for enhanced clarity:

Revised	New
ISA 320	**ISA 450**
Materiality in Planning and Performing an Audit	**Evaluation of Misstatements Identified During the audit**

The concept of materiality links ISAs **320**, **450** and **700**. It is applied in both **planning** and **performing** the audit.

Determining and Using Materiality

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

Deals with the auditor's responsibility to **apply** the **concept of materiality** appropriately in planning and performing an audit of financial statements.

ISA 450 Evaluation of Misstatements Identified During the audit (New)

Deals with the auditor's responsibility to **evaluate the effect** of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements.

ISA 700 Forming an Opinion and Reporting on Financial Statements

Deals with the auditor's responsibility, in **forming an opinion** on the financial statements, to conclude whether **reasonable assurance** has been obtained about whether the financial statements **as a whole** are **FREE from material misstatement.**

Materiality

What is Materiality?

ISA 320.2 Definition of materiality is replaced by description of **common characteristics**, often discussed in **financial reporting frameworks (FRFs)** the concept of materiality in the context of the **preparation and presentation of financial statements.**

- **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**;

Determining and Using Materiality

The auditor's determination of materiality:

ISA 320.4 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.

as a GROUP, and not their individual needs**.**

Determining and Using Materiality

The concept of materiality

ISA 320-5-6 The concept of materiality is applied by the auditor **both** in:

1- planning and

2- 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.

Objective of the Auditor

ISA 320-A1
ISA 200.11

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,

- 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 ISAs, in accordance with the auditor's findings.

Materiality and Audit Risk

ISA 320-A1
ISA 200.17

The auditor **obtains** reasonable assurance by obtaining **S**ufficient **A**ppropriate **A**udit **E**vidence (SAAE) to reduce audit risk to an acceptably low level.

ISA 320-A1
ISA 200.13c

Audit risk is:

- The risk that the auditor expresses an **inappropriate audit opinion** when the financial statements are **materially misstated**.

- A function of the risks of **material misstatement and detection risk.**

Materiality in Accounting (IASB Project)

Practice Statement

According to **the Conceptual Framework**, "**information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity**.

Therefore the concept of materiality acts as a **filter** through which **management sifts information**.

This filter ensures that financial statements include all **material information**—i.e. the financial information that could influence users' investment decisions.

What is Materiality?

Guide

Materiality has both **Qualitative** and **Quantitative** properties.

QUANTITATIVE

Relates to the **SIZE** of the misstatement, the larger it is the more likely it is to be material.

QUALITATIVE

relates to the **NATURE** of the misstatement,

an error caused by a **junior accounts clerk** would be much less likely to be considered material than a deliberate fraud by a **director** even if they were for the same amount.

Types of Materiality

ISA 320-A3

Determining materiality for the financial statements as a whole involves the exercise of professional judgment.

- **Starting with the** identification of the benchmark

Audit File Manual 1.3.3

- Determine the Overall Materiality **(OM)** or Materiality (M)
- Performance Materiality **(PM)**
- Clearly Trivial **(CT)** or Audit Misstatement Posting Threshold **(AMPT)**

Types of Materiality

There are two different, but **integrally related**, materiality concepts.

The first is at the **financial statements level** and is generally referred to simply as "**Materiality (M)" or Overall Materiality (OM)**

The second is at the **Assertion Testing Level** and is generally referred to as **"performance materiality" (PM)**.

Overall Materiality (OM)

When a misstatement (or the aggregate) is **significant enough to influence the decision of USER**, a material misstatement has occurred.

Below this threshold, the misstatement is generally regarded as not material.

This threshold, above which the financial statements would be materially misstated, is called **OVERALL MATERIALITY** or **MATERIALITY** .

i.e.: Let's assume that **the decision** of a financial statement **user group** would be **influenced** by a misstatement of **10,000$** in the financial statements.

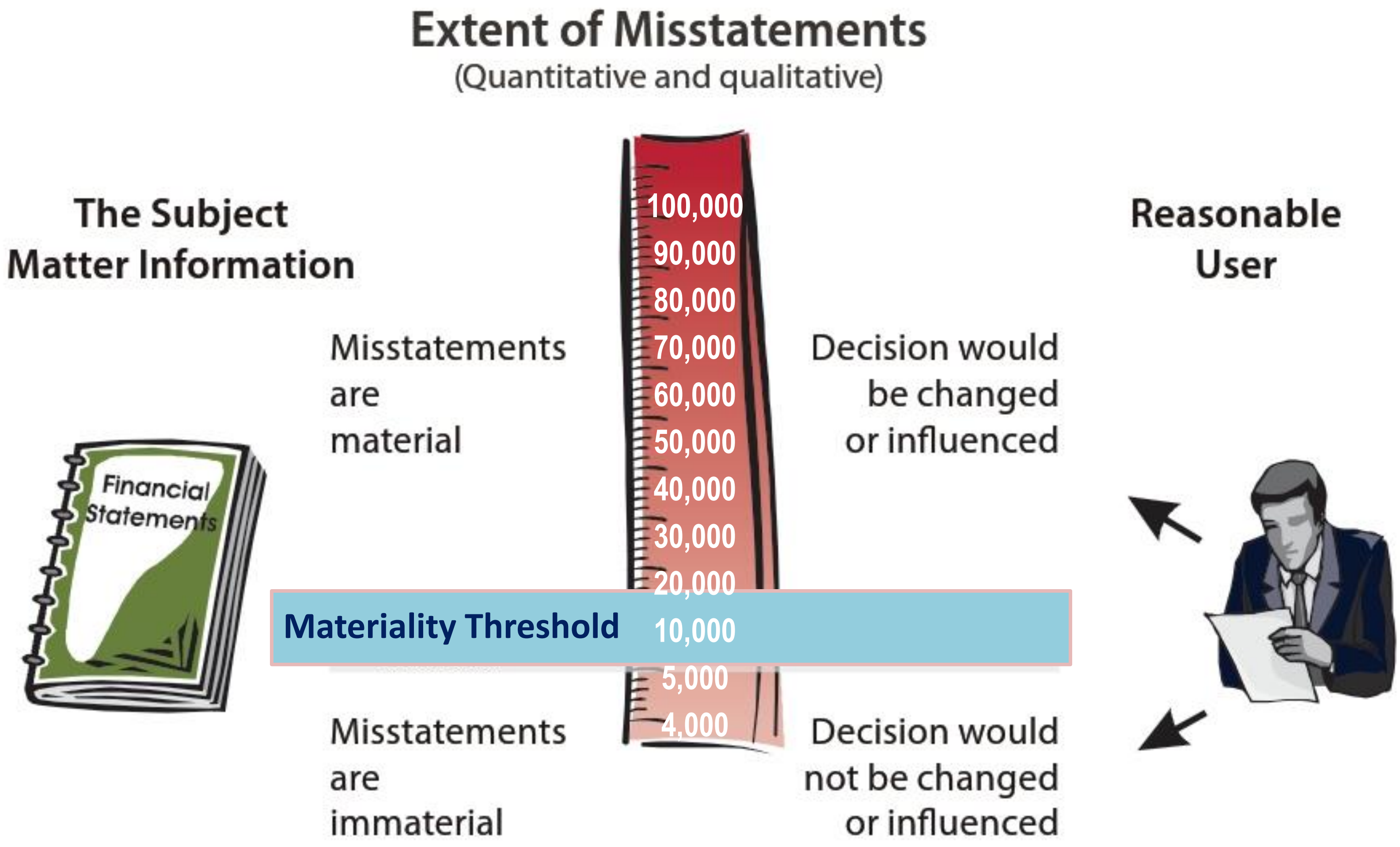
This would be the materiality (**M**) for the financial statements as a whole

(or **Overall Materiality OM**) for both the **PREPARER** and the **AUDITOR.**

Any misstatement that **exceeds the 10,000$** amount would result in the financial statements as being **materially misstated.**

OM would be changed during the audit if the auditor becomes aware of information that would have caused him to have determined a different amount.

Overall Materiality **OM**



Overall Materiality OM

Guide V1-P94

OM amount becomes one of the factors by which the maximum **success or failure of the audit** will be judged.

For example, assume **OVERALL MATERIALITY** was set at an amount of **20,000$.** If, as a result of performing audit procedures:

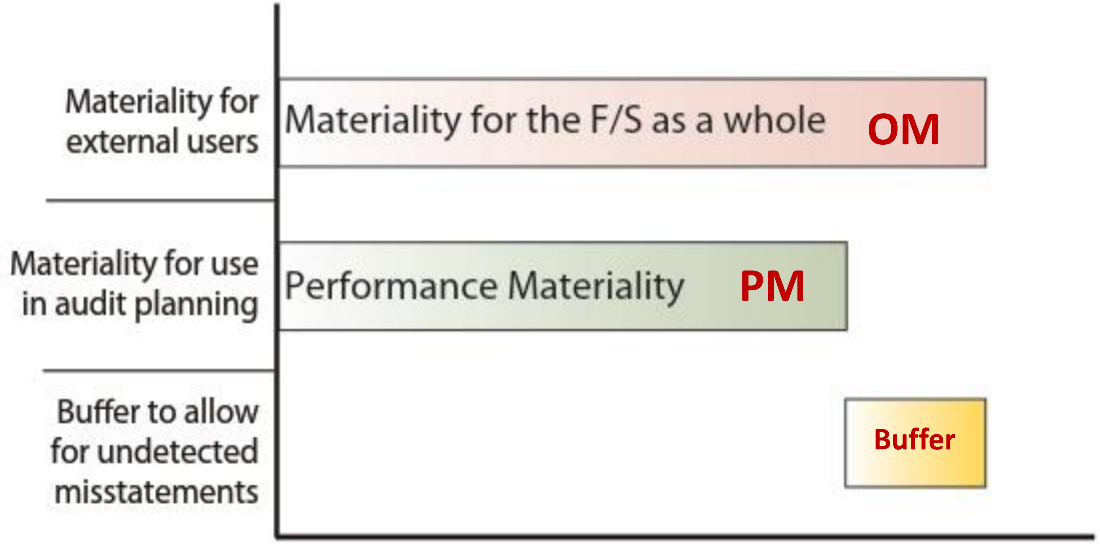
Case	Opinion Provided
No misstatements were identified, or were identified and corrected	**Unmodified opinion**
Some small (immaterial) misstatements were identified and **not** corrected	**Unmodified opinion**
Uncorrected misstatements **exceeding OM** materiality (of 20,000$) were found and **management was unwilling to make the necessary adjustments**	**Qualified or Adverse opinion**
Uncorrected errors **exceeding OM** materiality (of 20,000$) exist in the financial statements but were **not detected by the auditor**	**Inappropriate Unmodified** audit opinion may be issued **Audit Failure**

Performance Materiality PM

ISA 320.9

Performance Materiality **PM** means the **amount or amounts set by the auditor at LESS THAN materiality OM 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.

This Buffer provides some **assurance** for the auditor that undetected, and uncorrected misstatements, **will not accumulate** to reach an amount that would cause the F/S to be materially misstated.



Performance Materiality PM

Guide v1-7

Setting an appropriate amount for performance materiality will ensure that **more work** is performed, which increases the likelihood that misstatements (if they exist) will be identified.

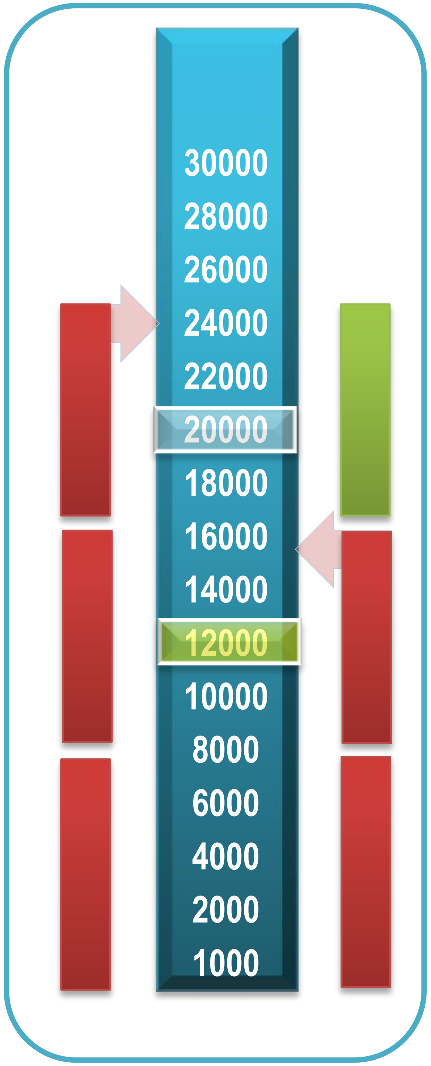
For example, if overall materiality **OM** was **20,000$** and audit procedures were planned to detect all errors in excess of 20,000$, it is quite possible that an error of, say, **8,000$ would go undetected**.

If **three** such errors existed, amounting to **24,000$**, the financial statements would be materially misstated.

However, if **performance materiality PM** was set at **12,000$,** it would be much more likely that at least one or all of the 8,000$ errors would be detected.

Even if only one of the three errors was identified and corrected, the **remaining misstatement of 16,000$** would be **less than the overall materiality**, and

the F/S as a whole would not be materially misstated.



Performance Materiality PM

Guide v2-6

The determination of **Performance Materiality PM** is not a simple mechanical calculation (such as 75% of overall materiality). It involves the exercise of **professional judgment** based on:

- **Specific Risk Factors** identified,
- Auditor's **understanding of the entity**, and
- Any matters the auditor has **identified in previous audit engagements**.

For example,

if there was a **high risk of errors in inventory pricing,**

PM could be lowered so that additional work is performed to identify the extent of misstatements.

Conversely, if the risk of misstatement in the **receivables balance** is assessed as **low**,

PM could be **raised**, resulting in less substantive audit work on the balance.

Performance Materiality PM

PM is generally between **60%** and **80%** of Overall Materiality.

Often the auditor uses 75% of Overall Materiality,

*(This range is a guide only and may be modified up or down by firms) according to specific **needs and conditions.***

Consider the example where an entity is regarded to have **very low inherent risk and no audit adjustments in the prior year.**

The engagement leader might make the decision in that case to set **PM** at **75%** of overall materiality,

but if the engagement had a **history** of **frequent audit adjustments**, the engagement leader might consider it appropriate to set the **PM** at a **lower level** to compensate for the additional risk. In that case, the decision might be taken to set the **PM** at **65%**, or perhaps even lower at **60% of overall materiality.**

Clearly Trivial (CT) amounts, or Audit Misstatement Posting Threshold (AMPT)

Audit File Manual 1.3.3

- Standard allows the auditor to set an amount below which misstatements would not need to be accumulated because the **accumulation** of such amounts would **not** have a **material effect on the financial statements.**
- Important to note that "clearly trivial" or "Audit Misstatement Posting Threshold" **does not mean "not material."**
- Matters that are clearly trivial are of a **wholly different and smaller order** of **magnitude** than materiality determined under ISA 320.
- These are matters that are clearly **inconsequential,** individually or in aggregate, when judged by any criteria of size, nature or circumstances.
- If there is any doubt as to whether a misstatement is clearly trivial, it is considered not clearly trivial..
- **CT** threshold is typically **between 0% and 10%** of OM, set using **professional judgment** taking into account the **PM**, the **history of misstatements** identified at the client, and **initial risk assessment**.
- **Primary reasons** for selecting the threshold should be **documented**.
- **Do not need to be reported** to TCWG

Documentation

ISA 320.14 The auditor shall include in the audit documentation 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).

Specific Materiality

There are some situations where misstatements of **lesser amounts** than materiality for the financial statements as a whole could **influence the economic decisions of users**, taken on the basis of the financial statements. Examples:

- Sensitive financial statement disclosures such as the remuneration of management and those charged with governance.
- **Related-party transactions.**
- Non-compliance with loan covenants, contractual agreements….
- Certain types of expenditures such as illegal payments or executives' expenses.
- Disclosure of significant events and important changes in Operations: Newly acquired businesses, expansion of operations, Introduction of new products and services….
- **for example,** a loan agreement may require the entity to maintain a specified minimum current ratio as at the statement of financial position date. The company may be tempted to overstate current assets or understate current liabilities. This might persuade the auditors to use a lower materiality threshold for current assets and current liabilities.

Types of Materiality - Determine Materiality

1

OM

Overall Materiality

Step1-
Select benchmark &
determine amount

Step 2-
Apply % of Benchmark
& Determine OM

Specific
Overall Materiality

2

PM

Performance Materiality

60% - 80% of OM
Often 75%

Specific
Performance Materiality

3

CT or AMPT

Clearly Trivial
Less than 10%

Never mix between OM and PM, because if you do you might set an incorrect Materiality level.

OM

OM is **affected** by:

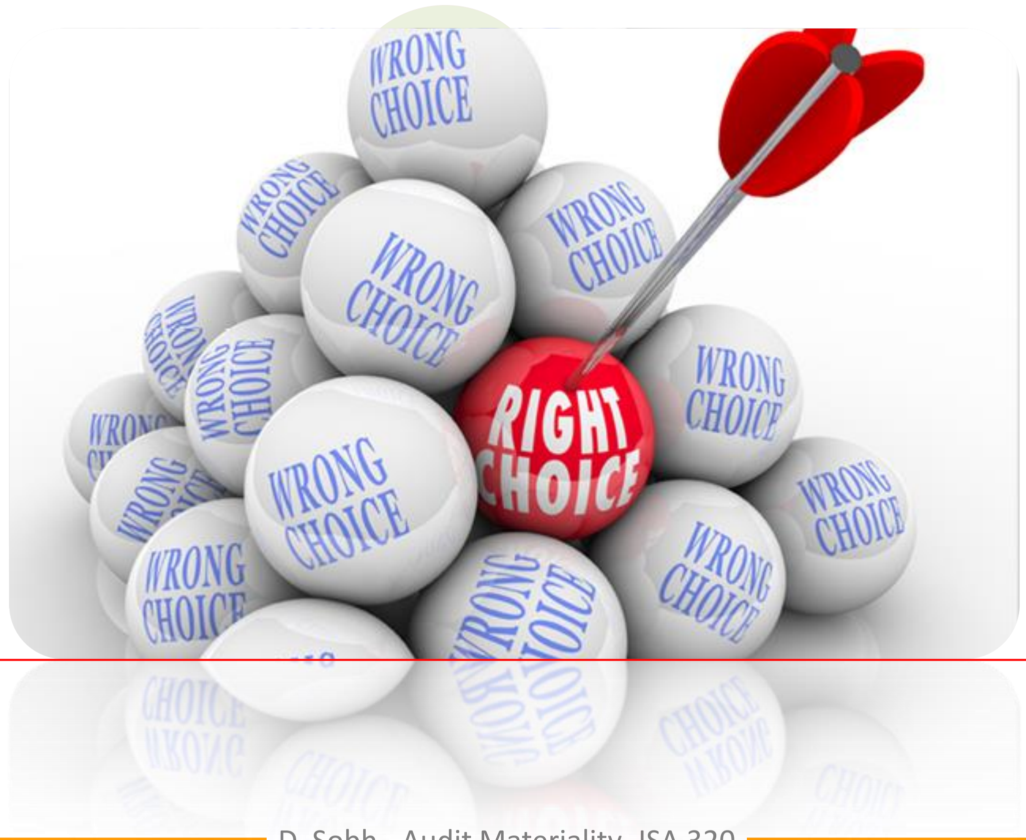
- The **perceived needs** and expectations of the **USERS** of the financial statements,
- Judged in light of **surrounding** circumstances.
- It is an assessment made of the common information needs of users as a **GROUP**, not of specific individual needs.

PM

PM Should reflect the **expected error rate**, which include:

- The auditor's **understanding** of the entity, updated during the performance of the risk assessment procedures
- The **nature** and **cause** of any **errors** found and its **surrounding factors** (such as a systems change, or the acquisition of another business).
- The **carry-forward effect** of uncorrected errors from the **previous year**.
- A margin for error.

Decide on Benchmark (s)
And determine Materiality



Step 1: Decide on Benchmark(s) and Determine Materiality

ISA 320.A7

An appropriate benchmark identification may be affected by:

- The **elements** of the financial statements (assets, liabilities, equity, revenue, expenses);
- **Users focus** (for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);
- The **nature of the entity**, 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.

How to Determine Materiality

Step 2:

Audit File Manual 1.3.3

Once the appropriate benchmark has been selected and the amount of the benchmark has been determined, OM is determined using the following ranges:

ISA 320.A7

Benchmark	Lower limit *	Upper limit *
Profit before tax (Net)	3%	10%
Total Revenue	½ %	2%
Total Assets / Total Liabilities	1%	2%
Gross Profit	2%	5%
Total Expenses	3%	10%
Equity	2%	5%

* These benchmarks, ranges and percentage limits are a guide only and may be modified up or down by firms using this methodology for their specific needs and conditions, including industry, public interest entity, regulatory and other jurisdiction considerations.

The benchmark is usually based on what is **important to users** of the financial report. For example;

- Users of a set of **Not-For-Profit** financial statements are unlikely to focus too much attention on **Profit or Revenue**, but instead may focus on **Expenses**
- Users of the financial statements of an **Investment Company** may care more about **Assets**
- Users of financial statements of a **for-profit manufacturing** entity may focus more on **Profit Before Tax**.

Step 1

Select Appropriate Benchmark

Revenue	Gross Profit	Expenses	Profit Bfr Tax	T. Assets T. Liabilities	Equity

Step 2

Determine OM

Benchmark x % (L. limit → U. limit = OM

Step 3

Determine PM

OM x (60 → 80) % = PM

Determine CT

OM x (1 → 10) % = CT

Use of Benchmarks in Determining Materiality

The actual benchmark to be used would be based on **professional judgment** in light of the particular circumstances of the entity.

Thank You

Dr. Daoud Sobh