ASA 320
(April 2006)

Auditing Standard ASA 320 *Materiality and Audit Adjustments*

Issued by the **Auditing and Assurance Standards Board**

Australian Government
Auditing and Assurance Standards Board

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PREFACE

Reasons for Issuing Auditing Standard ASA 320 *Materiality and Audit Adjustments*

The Auditing and Assurance Standards Board (AUASB) issues Auditing Standard ASA 320 *Materiality and Audit Adjustments*, due to the requirements of the legislative provisions explained below.

The *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (the CLERP 9 Act) established the AUASB as an independent statutory body under section 227A of the *Australian Securities and Investments Commission Act 2001*, as from 1 July 2004. Under section 336 of the *Corporations Act 2001*, the AUASB may make Auditing Standards for the purposes of the corporations legislation. These Auditing Standards are legislative instruments under the *Legislative Instruments Act 2003*.

Main Features

This Auditing Standard establishes mandatory requirements and provides explanatory guidance regarding the auditor's consideration of materiality and its relationship with audit risk in planning an audit and evaluating audit evidence. The Auditing Standard covers:

(a) preliminary assessments of materiality to plan audit procedures;

(b) quantitative and qualitative factors that impact on the auditor's assessment of materiality;

(c) the importance of qualitative materiality considerations when evaluating the impact, if any, of individual misstatements on the financial report and audit opinion; and

(d) reporting responsibilities arising from the identification of misstatements (whether or not material) including management representations regarding the effect of uncorrected misstatements and communication with those charged with governance.

Operative Date

This Auditing Standard is operative for financial reporting periods commencing on or after 1 July 2006.

Main changes from AUS 306 (June 2001) *Materiality and Audit Adjustments*

The main differences between this Auditing Standard and the Auditing Standard issued by the Auditing & Assurance Standards Board of the Australian Accounting Research Foundation, AUS 306 (June 2001) *Materiality and Audit Adjustments*, are that in this Auditing Standard:

1. The word ‘shall’, in the **bold-type** paragraphs, is the terminology used to describe an auditor’s mandatory requirements, whereas an auditor’s degree of responsibility is described in AUS 306 by the word ‘should’.

2. The explanatory guidance paragraphs provide guidance and illustrative examples to assist the auditor in fulfilling the mandatory requirements, whereas in AUS 306 some obligations are implied within certain explanatory paragraphs. Accordingly, such paragraphs have been re-drafted to clarify that they form part of the explanatory guidance.

3. The following implied obligations, in AUS 306, have been elevated and re-stated as specific mandatory requirements:

   (a) an auditor shall make a preliminary assessment of materiality to establish an appropriate quantitative materiality level to plan risk assessment procedures, further audit procedures at the assertion level, selection strategies and other audit procedures (paragraph 12);

   (b) the auditor shall consider qualitative factors, which impact on the materiality of individual misstatements, to assess:

      (i) the significance of the misstatement to the particular entity;

      (ii) the pervasiveness of the misstatement; and

      (iii) the effect of misstatement on the financial report as a whole (paragraph 21);

   (c) the auditor shall bring to the attention of management, misstatements identified during the audit, other than those that are clearly trivial, for correction prior to evaluating the effect of the remaining uncorrected misstatements (paragraph 24); and

(d) when the auditor concludes that uncorrected misstatements are immaterial individually and in aggregate to the financial report, the auditor shall endeavour to obtain representations from management to acknowledge:

  (i) uncorrected misstatements have been brought to their attention by the auditor; and

  (ii) they have considered the effect of any uncorrected misstatements, aggregated during and pertaining to the latest period, on the financial report and consider the misstatements are immaterial individually and in aggregate to the financial report taken as a whole (paragraph 35).

4. Additional explanatory guidance is provided in relation to misstatements, identified during the audit, that an auditor shall bring to the attention of management (paragraphs 25 and 26).

5. The objective of an audit of a financial report is included within explanatory guidance and refers to Auditing Standard ASA 200 *Objective and General Principles Governing an Audit of a Financial Report* (paragraph 8). AUS 306, however, requires that the objective of an audit of a financial report is to enable the auditor to express an opinion whether the financial report is prepared, in all material respects, in accordance with an applicable financial reporting framework.

AUTHORITY STATEMENT

The Auditing and Assurance Standards Board (AUASB) makes Auditing Standard ASA 320 *Materiality and Audit Adjustments* as set out in paragraphs 1 to 37, pursuant to section 227B of the *Australian Securities and Investments Commission Act 2001* and section 336 of the *Corporations Act 2001*.

This Auditing Standard is to be read in conjunction with the *Preamble to AUASB Standards*, which sets out the intentions of the AUASB on how the Auditing Standards are to be understood, interpreted and applied.

The mandatory requirements of this Auditing Standard are set out in **bold-type** paragraphs.

Dated 28 April 2006

M H Kelsall
Chairman - AUASB

AUDITING STANDARD ASA 320

Materiality and Audit Adjustments

Application

1 This Auditing Standard applies to:

> **(a) an audit of a financial report for a financial year, or an audit of a financial report for a half-year, in accordance with Part 2M.3 of the *Corporations Act 2001*; and**
>
> **(b) an audit of a financial report for any other purpose.**

2 This Auditing Standard also applies, as appropriate, to an audit of other financial information.

Operative Date

3 This Auditing Standard is operative for financial reporting periods commencing on or after 1 July 2006.

Introduction

4 The purpose of this Auditing Standard is to establish mandatory requirements and to provide explanatory guidance on materiality and its relationship with audit risk.

5 The auditor shall consider materiality and its relationship with audit risk.

6 "Materiality" means, in relation to information, that information which if omitted, misstated or not disclosed has the potential to adversely affect decisions about the allocation of scarce resources made by users of the financial report or the discharge of accountability by management or the governing body of the entity. Materiality is discussed in Accounting Standard AASB 1031 *Materiality*.

7 The Australian Accounting Standards explain the role of materiality in making judgements in the preparation and presentation of financial reports by the entity. This Auditing Standard explains the role of materiality in planning an audit and evaluating audit evidence. This includes:

- establishing a preliminary materiality level to plan audit procedures and selection strategies;
- assessing both qualitative and quantitative materiality factors when evaluating the results of audit procedures;
- re-assessing the preliminary materiality level used in planning the audit, based on the outcomes of audit procedures and actual results for the period, to determine whether there is a need to extend audit procedures; and
- evaluating the effect of uncorrected misstatements in the financial report and the impact on audit risk.

Materiality in the Context of an Audit

8 As identified in ASA 200 *Objective and General Principles Governing an Audit of a Financial Report*, the objective of an audit of a financial report is to enable the auditor to express an opinion whether the financial report is prepared, in all material respects, in accordance with an applicable financial reporting framework.

9 The auditor shall consider materiality when:

(a) determining the nature, timing and extent of audit procedures; and

(b) evaluating the effect of misstatements.

Preliminary Assessments of Materiality

10 When planning the audit, under paragraph 9 of this Auditing Standard, the auditor needs to consider what would make the financial report materially misstated. The auditor's assessment of materiality, related to specific account balances and classes of transactions, helps the auditor to select audit procedures that, in combination, can be expected to reduce audit risk to an acceptably low level, as discussed in ASA 300 *Planning an Audit of a Financial Report*.

11 Under ASA 315 *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, the auditor needs to identify and assess the risks of material misstatement and determine which of the risks identified are, in the auditor's judgement, risks that require special audit consideration. There is a relationship between materiality and the level of audit risk, that is the higher the

audit risk, the lower the materiality level. Under paragraph 9 of this Auditing Standard, the auditor needs to take this relationship between materiality and audit risk into account when determining the nature, timing and extent of audit procedures.

12 An auditor shall make a preliminary assessment of materiality to establish an appropriate quantitative materiality level to plan risk assessment procedures, further audit procedures at the assertion level, selection strategies and other audit procedures.

13 An auditor's consideration of materiality is a matter of professional judgement, and is affected by the auditor's perception of the financial information needs of users of the financial report. If an applicable financial reporting framework contains a definition of materiality, it provides a frame of reference to the auditor when determining materiality for planning and performing the audit. Ordinarily, the auditor considers prior year financial results, year-to-date results and balances, and budgets or forecasts for the financial period to establish a preliminary materiality level for planning the audit.

14 When establishing a preliminary assessment of materiality, under paragraph 12 of this Auditing Standard, the auditor needs to have regard to:

(a) the reliability of management information;

(b) factors which may indicate deviations from normal activities; and

(c) qualitative factors (refer paragraphs 20-22).

15 Under ASA 315, the auditor needs to assess the risks of material misstatement in relation to the financial report and in relation to, classes of transactions, account balances and disclosures. Materiality might be influenced by qualitative factors such as legal and regulatory requirements, and considerations relating to individual financial report account balances and relationships. This process could result in different materiality levels arising from consideration of both quantitative and qualitative factors depending on the aspect of the financial report being considered.

16 Although the auditor's preliminary assessment of materiality is largely based on quantitative factors, under paragraphs 12 and 21 of this Auditing Standard, the auditor needs to consider both the amount (quantity) and nature (quality) of misstatements when assessing the outcomes of audit procedures.

Quantitative Factors

17 Ordinarily, the auditor selects benchmark(s) appropriate to the entity's circumstances for a quantitative evaluation of materiality at the financial report level and in relation to classes of transactions, account balances and disclosures. For example, an evaluation of materiality based on profit impact might not be appropriate when the entity's earnings are volatile.

18 An auditor ordinarily applies a percentage to a chosen benchmark as a starting point in determining materiality. When identifying an appropriate benchmark, the auditor ordinarily has regard for factors such as the elements of the financial report, items users are likely to focus on, the nature of the entity, its life cycle, industry and economic environment, the size of the entity, ownership and financing and the relative volatility of the benchmark.

19 Under paragraph 27 of this Auditing Standard, the auditor needs to consider the possibility that the cumulative result of uncorrected misstatements below the materiality level could have a material effect on the financial report. 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 and the cumulative error is not corrected.

Qualitative Factors

20 The magnitude of a misstatement alone is only one factor used to assess materiality. Under paragraph 21 of this Auditing Standard, the auditor needs to review each misstatement in the context of information relevant to users of the financial report, by considering qualitative factors and the circumstances in which the misstatement or judgement has been made.

21 The auditor shall consider qualitative factors, which impact on the materiality of individual misstatements, to assess:

(a) the significance of the misstatement to the particular entity;

(b) the pervasiveness of the misstatement; and

(c) the effect of misstatement on the financial report as a whole.

22 Examples of qualitative material misstatements include:

- the inadequate or improper description of an accounting policy when it is likely that a user of the financial report would be misled by the description;
- failure to disclose a breach of regulatory requirements when it is likely that the consequent imposition of regulatory restrictions may significantly impair operating capability;
- matters which impact on the integrity of the financial records;
- matters which indicate weaknesses in the entity's system of internal control which may have further impact on various aspects of the financial reporting process; and
- matters which suggest fraudulent financial reporting practice, such as management attempting to "manage" or manipulate the entity's reported earnings. For example, intentional misstatements could be used by management as a means of achieving forecast results.

Materiality and Audit Risk in Evaluating Audit Evidence

23 The auditor's assessment of materiality and audit risk may be different at the time of initially planning the engagement from 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 the audit. For example, if the audit is planned prior to period end, the auditor will anticipate the results of operations and the financial position. If the actual results of operations and the actual financial position are substantially different to the anticipated amounts, the assessment of materiality and audit risk might also change.

24 The auditor shall bring to the attention of management, misstatements identified during the audit, other than those that are clearly trivial, for correction prior to evaluating the effect of remaining uncorrected misstatements.

25 "Clearly trivial" is not another expression for immaterial. Matters that are "clearly trivial" will be of a wholly different (smaller) order of magnitude than materiality used in planning and performing the audit, and will be matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances. Further, whenever there is

uncertainty about whether one or more items are "clearly trivial", the auditor ordinarily presumes the item is not "clearly trivial".

26 In deciding whether misstatements are "clearly trivial", the auditor uses professional judgement in considering matters such as:

- quantitative and qualitative factors;
- risk factors;
- the cumulative effect of detected misstatements (actual and likely); and
- the likely aggregate of undetected misstatements.

Evaluating the Effect of Uncorrected Misstatements

27 In evaluating the fair presentation of the financial report in accordance with an applicable financial reporting framework, the auditor shall assess whether the uncorrected misstatements that have been identified during the audit are material individually or in aggregate.

Individual Misstatements

28 Under paragraph 27 of this Auditing Standard, the auditor, when reviewing individual misstatements, needs to assess quantitative and qualitative materiality. The auditor ordinarily considers, for example, whether the item:

- is capable of precise measurement or whether it arises from an estimate and if so, the degree of imprecision inherent in the estimate;
- masks a change in earnings or other trends;
- concerns a segment or other portion of the entity's business that has been identified as playing a significant role in the entity's operations or profitability;
- affects compliance with regulatory requirements;
- affects compliance with loan covenants or other contractual requirements;

- has the effect of increasing management remuneration, for example, to satisfy the requirements for the award of bonuses or other incentives;
- involves concealment of an unlawful transaction;
- raises any other issues relating to the entity's business or industry; and
- may affect the decisions of users in response to certain types of disclosures.

29 Before aggregating the quantitative amounts of remaining uncorrected misstatements, under paragraph 27 of this Auditing Standard, the auditor needs to consider each misstatement separately:

(a) in relation to individual line item amounts, subtotals or totals in the financial report to assess whether a material misstatement in any of these items results in a material misstatement in the financial report taken as a whole;

(b) to assess whether it is appropriate to offset certain items. For example, the auditor considers whether it is appropriate to aggregate a misstatement relating to an estimated amount with an item capable of precise measurement, and the impact of the misstatements on disclosures in the financial report; and

(c) to assess the impact of a misstatement from prior periods and any cumulative effect becoming material in the current or subsequent reporting period. These types of misstatements may reflect on the adequacy of the financial records maintained by the entity, or may be indicative of internal control weaknesses.

30 In relation to individual uncorrected misstatements, under paragraph 27 of this Auditing Standard, the auditor needs to:

(a) assess whether the qualitative factors are not material and the individual item can be aggregated with other misstatements with no further action regarding the individual misstatement; or

(b) assess whether qualitative factors are material and that the misstatement requires correction by management; and

(c) assess whether the qualitative issues may have any further impact on materiality and extend audit procedures as appropriate and consider further action such as:

- reporting the item to management together with other matters arising from the audit;
- communicating findings to those charged with governance for resolution;
- considering whether the matter is required to be reported to particular regulators, or third parties under a loan covenant; and
- considering the effect of the item on the audit opinion.

Aggregated Misstatements

31 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 that affect the current financial report; and

(b) the auditor's best estimate of other misstatements which cannot be specifically identified (i.e. projected errors).

32 Under paragraph 27 of this Auditing Standard, the auditor needs to consider whether the aggregate of uncorrected misstatements is material.

33 When the aggregate of identified uncorrected misstatements approaches the quantitative materiality level, under ASA 330 *The Auditor's Procedures in Response to Assessed Risks,* the auditor needs to evaluate whether the assessments of risk of material misstatement remain appropriate. The risk of material misstatement increases when it is likely that the combined effect of:

- the aggregate identified uncorrected misstatements; and
- the likely aggregate of unidentified misstatements

could exceed the quantitative materiality level. When this is the case, under ASA 330, the auditor needs to evaluate whether it is necessary to perform further audit procedures and/or request management or those charged with governance to adjust the financial report for identified misstatements.

Reporting Responsibilities

34 The auditor shall express a modified opinion in accordance with ASA 701 *Modifications to the Auditor's Report*, if:

(a) those charged with governance refuse to adjust the financial report for material misstatements; and

(b) the results of extended audit procedures do not enable the auditor to conclude that the aggregate of uncorrected misstatements is not material.

Management Representations

35 When the auditor concludes that uncorrected misstatements are immaterial individually and in aggregate to the financial report, the auditor shall endeavour to obtain representations from management to acknowledge:

(a) uncorrected misstatements have been brought to their attention by the auditor; and

(b) they have considered the effect of any uncorrected misstatements, aggregated during and pertaining to the latest period, on the financial report and consider the misstatements are immaterial individually and in aggregate to the financial report taken as a whole.

Communication with Those Charged with Governance

36 Mandatory requirements and explanatory guidance regarding communications about uncorrected misstatements to those charged with governance are set out in ASA 260 *Communication of Audit Matters with Those Charged With Governance*.

Conformity with International Standards on Auditing

37 Except as noted below, this Auditing Standard conforms with International Standard on Auditing ISA 320 *Audit Materiality*, issued by the International Auditing and Assurance Standards Board of the International Federation of Accountants. The main differences between this Auditing Standard and ISA 320 are:

- The definition of materiality in ISA 320 is taken from the International Accounting Standards Committee's *Framework for the Preparation and Presentation of Financial Statements,* which describes materiality 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".

  Although ISA 320 recognises that both the amount (quantity) and nature (quality) of misstatements need to be considered, the focus of ISA 320 is on quantitative materiality. In contrast, the description of materiality provided in Australian Accounting Standards does not refer to the size of an item per se and the discussion in AASB 1031 recognises that "it may be necessary to treat as material an item or an aggregate of items which would not be judged to be material on the basis of the amount involved, because of their nature….". Therefore, this Auditing Standard includes further discussion of qualitative factors which may impact on the auditor's assessment of materiality (paragraph 20).

- This Auditing Standard includes the following mandatory requirements that are not included in ISA 320:

  - ♦ An auditor shall make a preliminary assessment of materiality to establish an appropriate quantitative materiality level to plan risk assessment procedures, further audit procedures at the assertion level, selection strategies and other procedures (paragraph 12).

  - ♦ The auditor shall consider qualitative factors, which impact on the materiality of individual misstatements, to assess:

    - ○ the significance of the misstatement to the particular entity;

        - the pervasiveness of the misstatement; and
        - the effect of misstatement on the financial report as a whole (paragraph 21).
    - The auditor shall bring to the attention of management, misstatements identified during the audit, other than those that are clearly trivial, for correction prior to evaluating the effect of remaining uncorrected misstatements (paragraph 24).
    - When the auditor concludes that uncorrected misstatements are immaterial individually and in aggregate to the financial report, the auditor shall endeavour to obtain representations from management to acknowledge:
        - uncorrected misstatements have been brought to their attention by the auditor; and
        - they have considered the effect of any uncorrected misstatements, aggregated during and pertaining to the latest period, on the financial report and consider the misstatements are immaterial individually and in aggregate to the financial report taken as a whole (paragraph 35).
- ISA 320 requires that 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. In this Auditing Standard, the objective of an audit of a financial report is included within explanatory guidance that refers to Auditing Standard ASA 200 *Objective and General Principles Governing an Audit of a Financial Report* (paragraph 8).
- Explanatory guidance is provided in relation to misstatements, identified during the audit, that an auditor shall bring to the attention of management (paragraphs 25 and 26).

- ISA 320 requires the evaluation of the effects of misstatements by considering whether the *aggregate* of uncorrected misstatements that have been identified during the course of the audit is material. In this Auditing Standard the auditor, having regard to both qualitative and quantitative factors, is required to assess whether uncorrected misstatements that have been identified during the audit, are material, *individually* or in *aggregate* (paragraph 27).

- ISA 320 includes a requirement for the auditor to consider the need to report identified material misstatements resulting from error, to those charged with governance. In this Auditing Standard, communication of uncorrected misstatements to those charged with governance, is included in explanatory guidance that refers to Auditing Standard ASA 260 *Communication of Audit Matters with Those Charged with Governance* (paragraph 36).

Compliance with this Auditing Standard enables compliance with ISA 320.