MATERIALITY IN PLANNING AND PERFORMING AN AUDIT: CAS 320

- The auditor is to apply the concept of materiality in planning and performing the audit
- Misstatements are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of **users**
  - **Always tie the materiality level chosen for the audit back to the users of the F/S**

Determining Materiality and Performance Materiality When Planning the Audit

- When setting the overall audit strategy, the auditor should determine materiality for the **F/S as a whole**
  - If there is one or more classes of transactions, account balances or disclosures for which **misstatements of lesser amounts** could reasonably be expected to influence the economic decisions of **users** the auditor should also determine the materiality level for those particular classes of transactions, account balances or disclosures (see **performance materiality** below**)**
  - 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 F/S as a whole
  - Some factors to consider in selecting a benchmark include:
    - **Elements of the F/S (**assets, liabilities, equity, revenue, expenses)
    - **Items users are more focused on** (i.e. for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets)
    - **The relative volatility of the benchmark** (if benchmark is volatile, say net income, you may want to choose another benchmark that is stable like revenue)
    - The **nature of the entity**, where the entity is 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** (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)
  - Some **common benchmarks** include: **profit before tax, total revenue, gross profit and total expenses, total equity or net asset value**
  - When profit before tax from continuing operations is **volatile**, other benchmarks may be more appropriate, such as gross profit or total revenues
  - Determining a **percentage** to be applied to a chosen benchmark involves the exercise of **professional judgment**
    - the auditor may consider **5% of profit before tax from continuing operations** to be appropriate for a **profit-oriented entity**
    - auditor may consider **1% of total revenue or total expenses** to be appropriate for a **not-for-profit entity**

- What is **performance materiality**?
  - Performance materiality is the materiality that is set lower than the materiality for the F/S as a whole:
    - for ensuring that the aggregate of all uncorrected and undetected misstatements do not exceed the materiality level for the F/S as a whole; or
    - for particular classes of transactions, account balances or disclosures

- The auditor should determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures
- Auditors do not have to determine a lower materiality for all assertions, accounts, transactions or disclosures; they should only determine a lower materiality (performance materiality) for assertions, accounts, transactions, disclosures **if the users would be influenced by a lower amount**

Revision as the Audit Progresses

- **Revise the materiality** for the F/S as a whole (and if applicable, the performance materiality), if you become aware of new information throughout the audit
  - For example, if initially the materiality was set at 5% of income, and assuming the client made an error that impacted the profit came up in the audit, the auditor should revise the materiality to 5% of the corrected income

Documentation

- Document the following
  - Materiality for the F/S as a whole
  - If applicable, the materiality level for particular classes of transactions, account balances or disclosures
  - Performance materiality
  - Any revision of the above amounts as the audit progressed