

EXPOSURE DRAFT

ED 33/05
(December 2005)

Proposed Auditing Standard: Materiality and Audit Adjustments (Re-issuance of AUS 306)

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



Australian Government

Auditing and Assurance Standards Board

Commenting on this Exposure Draft

Comments on this Exposure Draft should be forwarded so as to arrive by 31 January 2006. Comments should be addressed to:

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A copy of all non-confidential submissions will be placed on public record on the AUASB website: www.auasb.gov.au.

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PREFACE

Reasons for Issuing ED 33/05

The Auditing and Assurance Standards Board (AUASB) is proposing to re-issue Auditing Standard (AUS 306) *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 will be legislative instruments under the *Legislative Instruments Act 2003*.

Main Proposals

This proposed Auditing Standard establishes mandatory requirements and provides explanatory guidance regarding the auditor's consideration of materiality in planning an audit and evaluating audit evidence. The proposed 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.

Proposed Operative Date

It is intended that this proposed Auditing Standard will be operative for financial reporting periods commencing on or after 1 July 2006.

Main changes from existing AUS 306 (June 2001)

The main differences between this proposed Auditing Standard and the Auditing Standard issued by the former Auditing & Assurance Standards Board of the AARF that it supersedes, AUS 306 *Materiality and Audit Adjustments* (June 2001), is that in this proposed 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 was previously described by the word 'should';
2. the explanatory paragraphs provide guidance and illustrative examples to assist the auditor in fulfilling the mandatory requirements, previously some obligations were implied within certain explanatory paragraphs. Accordingly, such paragraphs have been redrafted to clarify that the matter forms part of the explanatory guidance;
3. the following implied obligations, previously 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 procedures (paragraph 12);
 - (b) the auditor shall decide, using professional judgement, whether to document misstatements below the materiality level. (paragraph 19);
 - (c) 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 24); and
 - (d) 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

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effect of the remaining uncorrected misstatements (paragraph 27).

A Table of Proposed Changes is provided as an attachment to this Exposure Draft.

Request for Comments

Comments are invited on this Exposure Draft of the proposed re-issuance of Auditing Standard (AUS 306) *Materiality and Audit Adjustments* by 31 January 2006. The AUASB would prefer that respondents express a clear overall opinion on whether the proposed Auditing Standard, as a whole, is supported and that this opinion be supplemented by detailed comments, whether supportive or critical, on any matter. The AUASB regards both critical and supportive comments as essential to a balanced review of the proposed Auditing Standard.

AUTHORITY STATEMENT

The Auditing and Assurance Standards Board (AUASB) makes Auditing Standard << >> *Materiality and Audit Adjustments* as set out in paragraphs 1 to 38, 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.

AUDITING STANDARD

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 Accounting Standards in Australia 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:

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- (a) establishing a preliminary materiality level to plan audit procedures and selection strategies;
- (b) assessing both qualitative and quantitative materiality factors when evaluating the results of audit procedures;
- (c) 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;
- (d) 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 AUS 202 *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, pursuant to paragraph 9 of this Auditing Standard, the auditor is required 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 required by AUS 302 *Planning an Audit of a Financial Report*.

11 Pursuant to AUS 402 *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement*, an auditor is required 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

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the higher the audit risk, the lower the materiality level. Pursuant to paragraph 9 of this Auditing Standard, the auditor is required 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 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, pursuant to paragraph 12 of this Auditing Standard, the auditor is required 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 23-25).
- 15 Pursuant to AUS 402, the auditor is required 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, pursuant to paragraphs 12 and 24 of this Auditing Standard, the auditor is required 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 is a not-for-profit organisation, or 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 The auditor shall decide, using professional judgement, whether to document misstatements below the materiality level.**
- 20 In deciding whether to document misstatements below the materiality level the auditor uses professional judgement to consider:
- (a) qualitative factors;
 - (b) the cumulative effect of detected misstatements (actual and likely);
 - (c) the likely aggregate of undetected misstatements; and
 - (d) misstatements that are clearly trivial.
- 21 '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', pursuant to paragraph 19 of this Auditing Standard, the auditor is required to presume the item is not 'clearly trivial'.
- 22 The auditor ordinarily considers the possibility that the cumulative result of 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

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misstatement if that error is repeated each month and the cumulative error is not corrected.

Qualitative Factors

- 23 The magnitude of a misstatement alone is only one factor used to assess materiality. Pursuant to paragraph 24 of this Auditing Standard, the auditor is required 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 (refer paragraph 29).
- 24 **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.**
- 25 Examples of qualitative material misstatements include:
- (a) 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;
 - (b) failure to disclose a breach of regulatory requirements when it is likely that the consequent imposition of regulatory restrictions may significantly impair operating capability;
 - (c) matters which impact on the integrity of the financial records;
 - (d) 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
 - (e) 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

- 26 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.
- 27 **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.**

Evaluating the Effect of Uncorrected Misstatements

- 28 **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

- 29 Pursuant to paragraph 28 of this Auditing Standard, the auditor is required, when reviewing individual misstatements, to assess quantitative or qualitative materiality. The auditor considers, for example, whether the item:
- (a) is capable of precise measurement or whether it arises from an estimate and if so, the degree of imprecision inherent in the estimate;
 - (b) masks a change in earnings or other trends;
 - (c) 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;
 - (d) affects compliance with regulatory requirements;
 - (e) affects compliance with loan covenants or other contractual requirements;

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- (f) has the effect of increasing management remuneration, for example, to satisfy the requirements for the award of bonuses or other incentives;
 - (g) involves concealment of an unlawful transaction;
 - (h) raises any other issues relating to the entity's business or industry;
 - (i) may affect the decisions of users in response to certain types of disclosures.
- 30 Before aggregating the quantitative amounts of remaining uncorrected misstatements, pursuant to paragraph 28 of this Auditing Standard, the auditor is required 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;
 - (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.
- 31 In relation to individual uncorrected misstatements, pursuant to paragraph 28 of this Auditing Standard, the auditor is required 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

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

Aggregated Misstatements

- 32 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).
- 33 Pursuant to paragraph 28 of this Auditing Standard, the auditor is required to consider whether the aggregate of uncorrected misstatements is material.
- 34 When the aggregate of identified uncorrected misstatements approaches the quantitative materiality level, pursuant to AUS 406, the auditor is required 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, pursuant to AUS 406, the auditor is required to evaluate whether it is necessary to perform further audit procedures and/or

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request management to adjust the financial report for identified misstatements.

Reporting Responsibilities

35 The auditor shall express a modified opinion in accordance with AUS 702 (Part B) *Modifications to the Independent Auditor's Report*, if:

- (a) those charged with governance refuse to adjust the financial report; 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

36 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

37 Mandatory requirements and explanatory guidance regarding communications about uncorrected misstatements to those charged with governance are set out in AUS 710 *Communication of Audit Matters With Those Charged With Governance*.

Conformity with International Standards on Auditing

38 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 difference(s) between this Auditing Standard and ISA 320 are:

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- 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 definition of materiality provided in Accounting Standards in Australia 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 AUS includes further discussion of qualitative factors which may impact on the auditor’s assessment of materiality.
- In this proposed Auditing Standard, 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).
- In this proposed Auditing Standard, the auditor shall decide, using professional judgement, whether to document misstatements below the materiality level (paragraph 19).
- In this proposed Auditing Standard, 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

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- ◆ the effect of misstatement on the financial report as a whole (paragraph 24)
- 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. This proposed Auditing Standard requires consideration of whether *individual* misstatements are material, having regard to both qualitative and quantitative factors, prior to considering whether an aggregation of misstatements is appropriate or material.

Compliance with this Auditing Standard enables compliance with ISA 320.

Table of Proposed Changes from AUS 306 <i>Materiality and Audit Adjustments</i>
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Paragraph No. in Proposed Exposure Draft	Status (Requirement, Guidance, Footnote or Appendix)	Description of Proposed Change(s)
1, 2	Requirement	New Application paragraphs.
3	Requirement	Re-position Operative Date paragraph.
5, 9, 12, 19, 24, 27, 28, 35, 36	Requirement	Replace “should” with “shall”. Include “shall” in new requirements.
17	Guidance	Insert “ordinarily” to clarify implied obligations.
10, 11, 14, 15, 16, 21, 23, 29, 30, 31, 33, 34	Guidance	Insert “pursuant to...the auditor is required to...” to clarify implied obligations.
31, 35, 37	Requirement / Guidance	Replace the word ‘management’ with ‘those charged with governance’. Include the term ‘those charged with governance’ in new text.
36	Requirement	Re-word.
10	Guidance	Additional reference.
12, 19, 24, 27, 36	Requirements	Elevations and re-word.
11, 13, 18, 20, 21	Guidance	New guidance.
15	Guidance	New reference and re-word.
6, (Between 17 & 22); and (after 25)	Guidance	Deletions (see AUS 306 .14 & .15); and (AUS 306 .20 - .23).

Paragraph No. in Proposed Exposure Draft	Status (Requirement, Guidance, Footnote or Appendix)	Description of Proposed Change(s)
29, 34	Guidance	New wording & deletions.
35	Requirements	Update wording.
(After 35)	Guidance	Deletion (see AUS 306 .35).
37	Guidance	Deletion and re-word.