Auditing Standard **AUS 306**

(June 2001)

Materiality and Audit Adjustments

Prepared by the **Auditing & Assurance Standards Board**
of the **Australian Accounting Research Foundation**

Issued by the
Australian Accounting Research Foundation
on behalf of **CPA Australia** and **The Institute of Chartered Accountants in Australia**

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ISSN 1324-4183

AUS 306 "MATERIALITY AND AUDIT ADJUSTMENTS"

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Background to Revision

MAIN FEATURES OF THE STANDARD

This Auditing Standard (AUS) establishes standards and provides guidance regarding the auditor's consideration of materiality in planning an audit and evaluating audit evidence. The AUS provides guidance regarding:

(a) a preliminary assessment of materiality to plan audit procedures and selection strategies;

(b) quantitative and qualitative factors which 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;

(d) consideration of the potential impact of misstatements in relation to internal control, financial records and illegal acts;

(e) the reporting responsibilities arising from the identification of misstatements (whether or not material), including management representations regarding the effect of uncorrected misstatements and communication with the governing body or audit committee.

Introduction

.01 The purpose of this Auditing Standard (AUS) is to establish standards and provide guidance on materiality and its relationship with audit risk.

.02 ***The auditor should consider materiality and its relationship with audit risk.***

.03 "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 the management or governing body of the entity. Materiality is discussed in the Accounting Standards AASB 1031/AAS 5 "Materiality" and AASB 1001/AAS 6 "Accounting Policies" and in Statement of Accounting Concepts SAC 3 "Qualitative Characteristics of Financial Information".

.04 The accounting standards explain the role of materiality in making judgments in the preparation and presentation of financial reports by the entity. This AUS explains the role of materiality in planning an audit and evaluating audit evidence. This includes:

(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

.05 ***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 identified financial reporting framework.***

.06 ***The auditor should consider materiality when:***

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

(b) ***evaluating the effect of misstatements.***

Preliminary Assessments of Materiality

.07 When planning the audit, the auditor considers 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.

.08 There is a relationship between materiality and the level of audit risk, that is the higher the audit risk, the lower the materiality level. The auditor takes this relationship between materiality and audit risk into account when determining the nature, timing and extent of audit procedures.

.09 The auditor makes a preliminary assessment of materiality to establish an appropriate quantitative materiality level to plan audit procedures and selection strategies. Quantitative thresholds used as guidance for determining the materiality of the amount of an item or an aggregate of items are, of necessity, drawn at arbitrary levels (AASB 1031 paragraph 4.1.6). 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.

.10 When establishing a preliminary assessment of materiality the auditor has regard to:

(a) the reliability of management information;

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

(c) qualitative factors (refer paragraphs .17-.23).

.11 The auditor considers materiality in relation to the financial report and in relation to individual account balances, classes of transactions and disclosures. Materiality may be influenced by qualitative factors such as legal and regulatory requirements, and considerations relating to individual financial report account balances and relationships. This process may result in different materiality levels arising from consideration of both quantitative and qualitative factors depending on the aspect of the financial report being considered.

.12 Although the auditor's preliminary assessment of materiality is largely based on quantitative factors, when assessing the outcomes of audit procedures both the amount (quantity) and nature (quality) of misstatements need to be considered.

Quantitative Factors

.13 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 individual account balances, classes of transactions and disclosures. For example, an evaluation of materiality based on profit impact may not be appropriate when the entity is a not-for-profit organisation, or when the entity's earnings are volatile.

.14 A quantitative materiality level, represented by a percentage or dollar threshold, provides a basis or initial step for the preliminary assumption that without considering all relevant circumstances, a deviation of less than the specified amount is unlikely to be material. The auditor applies this materiality level to audit procedures where appropriate and uses it to evaluate the outcome of those procedures. The auditor uses professional judgment to document misstatements below the materiality level, having regard to the qualitative factors which may cause misstatements of quantitatively small amounts to be material.

.15 For example if an amount of $10,000 was selected as an appropriate benchmark for a quantitative evaluation of materiality in the financial report of a specific entity, then an amount of say $2,000 might be assessed as the materiality level appropriate for capturing and recording individual misstatements.[1] However, the auditor may decide to document certain amounts below $2,000 if qualitative factors indicate that the misstatement could be material. Examples

[1] $10,000 and $2,000 are used as examples only and are not indicative of recommended materiality levels. An acceptable dollar-materiality level is determined by the auditor having regard to the particular circumstances of the individual entity.

of qualitative factors, which prompt the recording of amounts below the materiality level selected, include a breach of a covenant, or where a number of small amounts might be significant in aggregate (refer paragraph.23).

.16 The auditor considers the possibility that the cumulative result of misstatements of small amounts below the threshold 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

.17 The magnitude of a misstatement alone is only one factor used to assess materiality. The auditor reviews 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 judgment has been made (refer paragraph .28).

.18 The auditor considers 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 (for example the misstatement might affect the presentation of numerous items in the financial report);

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

.19 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 the 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 (paragraph .20);

(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 (paragraph .21);

(e) matters which suggest fraudulent financial reporting practice (paragraph .22), or that management is 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 (paragraph .23).

Financial Records

.20 The auditor considers the impact of misstatements on the entity's obligation to maintain adequate financial records. The auditor considers the following issues to determine any further action required:

(a) the significance of the misstatement;

(b) how the misstatement arose;

(c) the clarity of authoritative accounting guidance relating to the misstatement.

Internal Control

.21 Misstatements, accidental or intentional, may indicate weaknesses in the entity's system of internal control designed to detect and deter improper accounting and financial reporting. The auditor considers management culture as an important factor contributing to the integrity of the financial reporting process.

Irregularities

.22 The auditor adopts an attitude of professional scepticism to determine whether intentional immaterial misstatements are indicative of fraudulent financial reporting practice. For example, the auditor considers:

(a) the falsification or alteration of accounting records;

(b) the misrepresentation or omission of events, transactions or other information in the financial report;

(c) the intentional misapplications of accounting principles relating to amounts, classifications, the manner of presentation or disclosure in the financial report.

Intentional Misstatements

.23 The auditor adopts an attitude of professional scepticism to determine whether management has intentionally misstated certain items (possibly by amounts below the audit materiality level) to "manage" reported earnings. Similarly, the auditor is cautious where "industry practice" represented by the client appears contrary to accounting standards.

Materiality and Audit Risk in Evaluating Audit Evidence

.24 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 may also change.

.25 If, after planning for specific audit procedures, the auditor determines that the acceptable materiality level needs to be lowered, then audit risk is increased. The auditor would compensate for this by either:

(a) reducing the assessed level of control risk, where this is possible, and supporting the reduced level by carrying out extended or additional tests of control; or

(b) reducing detection risk by modifying the nature, timing and extent of planned substantive procedures.

.26 Misstatements identified during the audit are brought to the attention of the appropriate level of management for correction, prior to evaluating the effect of remaining uncorrected misstatements.

Evaluating the Effect of Uncorrected Misstatements

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

Individual Misstatements

.28 When reviewing individual misstatements to assess quantitative or qualitative materiality, the auditor considers 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) hides a failure to meet analysts' consensus expectations for the entity;

(d) changes a loss into a profit or vice versa;

(e) 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;

(f) affects compliance with regulatory requirements;

(g) affects compliance with loan covenants or other contractual requirements;

(h) has the effect of increasing management compensation, for example, to satisfy the requirements for the award of bonuses or other incentives;

(i) involves concealment of an unlawful transaction;

(j) raises any other issues relating to the entity's business or industry;

(k) may affect the decisions of users in response to certain types of disclosures.

.29 Before aggregating the numerical amounts of remaining uncorrected misstatements the auditor considers 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.

.30 In relation to individual uncorrected misstatements, the auditor:

(a) assesses that 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) assesses that the qualitative factors are material and that the misstatement requires correction by management; and

(c) assesses whether the qualitative issues may have any further impact on materiality and extends audit procedures as appropriate and considers further action such as:

(i) reporting the item to management together with other matters arising from the audit;

(ii) communicating findings to the audit committee 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

.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 (ie. projected errors).

.32 The auditor considers whether the aggregate of uncorrected misstatements is material. If the auditor concludes that the misstatements may be material, the auditor considers reducing audit risk by extending audit procedures or requesting management to adjust the financial report. In any event, management may want to adjust the financial report for the misstatements identified.

.33 If the aggregate of the uncorrected misstatements that the auditor has identified approaches the quantitative materiality level, the auditor considers whether it is likely that undetected misstatements, when taken with aggregate uncorrected misstatements, could exceed the quantitative materiality level. The auditor considers performing additional audit procedures or requesting management to adjust the financial report for identified misstatements.

Reporting Responsibilities

.34 ***The auditor should express a qualified opinion in accordance with AUS 702 "The Audit Report on a General Purpose Financial Report" if:***

(a) management refuses 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.

Engagement Letter

.35 Management is responsible for adjusting the financial report to correct material misstatements. The auditor clarifies this responsibility in the engagement letter or other written agreement and requests that management will provide a statement in the management representation letter regarding the effect of any

uncorrected misstatements aggregated by the auditor during the audit.

Management Representations

.36 When the auditor concludes that uncorrected misstatements are immaterial individually and in aggregate to the financial report, the auditor obtains representations from management to acknowledge:

(a) uncorrected misstatements have been brought to management's attention by the auditor; and

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

Communication with Management and the Audit Committee

.37 Matters underlying misstatements, whether or not corrected by the entity, could potentially cause future financial reports to be materially misstated, even when the adjustment is not material in the current period. The auditor uses professional judgment to decide whether to communicate to the governing body or the audit committee:

(a) the details of uncorrected misstatements aggregated by the auditor during the audit, and determined by management to be immaterial individually and in aggregate to the financial statements taken as a whole;

(b) matters arising from a review of misstatements, indicative of concerns relating to the quality of accounting principles applied by management (consistency, application, clarity and completeness) and their impact on financial report.

Operative Date

.38 This AUS is operative from date of issue and supersedes AUS 306 issued in October 1995.

Compatibility with International Standards on Auditing

.39 Except for the matters noted below, the basic principles and essential procedures of this AUS and of International Standard on Auditing ISA 320, Audit Materiality, are consistent in all material respects.

(a) 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 Australian Accounting Standards does not refer to the size of an item per se and the discussion in AASB 1031 paragraph 4.1.3 (b) 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.

(b) 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 AUS 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.

(c) This AUS provides guidance in respect of the reporting responsibilities arising from the identification of misstatements (whether or not material), including management representations regarding the effect of uncorrected misstatements and communication with the audit committee. Guidance in respect of the reporting responsibilities arising from the identification of significant differences is provided in

ISA 260 “Communications of Audit Matters with Those Charged with Governance”. ISA 260 requires the auditor to consider audit matters of governance interest that arise from the audit of financial statements and communicate them with those charged with governance, and includes reference to:

- audit adjustments, whether or not recorded by the entity that have, or could have, a significant effect on the entity’s financial statements; and
- disagreements with management about matters that, individually or in aggregate, could be significant to the entity’s financial statements or the auditor’s report. These communications include consideration of whether the matter has, or has not been resolved and the significance of the matter.

AUS 306 "MATERIALITY AND AUDIT ADJUSTMENTS"

BACKGROUND TO REVISION

This section does not form part of the standard. It is a summary of the reasons for the current revision to the Standard and of key issues which have been considered by the Auditing & Assurance Standards Board (AuASB) as part of this revision.

1. This Auditing Standard AUS 306 "Materiality and Audit Adjustments" revises AUS 306 "Materiality" issued in October 1995, to further clarify existing practice regarding the auditor's consideration of materiality in planning an audit and evaluating audit evidence.

2. The auditor ordinarily uses a quantitative materiality level as a threshold to plan audit procedures and selection strategies. However, although the auditor's preliminary assessment of materiality is largely based on quantitative factors, when evaluating audit evidence, both the amount (quantity) and nature (quality) need to be considered.

3. The major area of revision to the guidance relates to the auditor's evaluation of the effect of misstatements.

4. The guidance recognises that as the auditor's knowledge of the entity changes as the audit progresses, the quantitative materiality level selected for a preliminary assessment of materiality may be revised during the course of the audit.

5. The revised AUS recognises the need to evaluate individual misstatements to assess quantitative and qualitative materiality. A consideration of qualitative factors will not always result in adjustment of individual items in the financial report. However, matters arising from a consideration of qualitative factors ordinarily impact on corporate governance or internal control. Therefore the auditor communicates with management and the audit committee, as appropriate. Further guidance regarding reporting responsibilities is also provided in the revised AUS.

6. The revised AUS provides discussion of matters for consideration by the auditor prior to aggregating the numerical amounts of remaining uncorrected misstatements.