Auditing Standards and Practices Council

Philippine Standard on Auditing 320

AUDIT MATERIALITY

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CONTENTS

Philippine Standards on Auditing (PSAs) are to be applied in the audit of financial statements. PSAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

PSAs contain the basic principles and essential procedures (identified in bold type black lettering) together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be interpreted in the context of the explanatory and other material that provide guidance for their application.

To understand and apply the basic principles and essential procedures together with the related guidance, it is necessary to consider the whole text of the PSA including explanatory and other material contained in the PSA not just that text which is black lettered.

In exceptional circumstances, an auditor may judge it necessary to depart from a PSA in order to more effectively achieve the objective of an audit. When such a situation arises, the auditor should be prepared to justify the departure.

PSAs need only be applied to material matters.

The PSAs issued by the Auditing Standards and Practices Council (Council) are based on International Standards on Auditing (ISAs) issued by the International Auditing Practices Committee of the International Federation of Accountants.

The ISAs on which the PSAs are based are generally applicable to the public sector, including government business enterprises. However, the applicability of the equivalent PSAs on Philippine public sector entities has not been addressed by the Council. It is the understanding of the Council that this matter will be addressed by the Commission on Audit itself in due course. Accordingly, the Public Sector Perspective set out at the end of an ISA has not been adopted into the PSAs.

Introduction

1. The purpose of this Philippine Standard on Auditing (PSA) is to establish standards and provide guidance on the concept of materiality and its relationship with audit risk.

2. **The auditor should consider materiality and its relationship with audit risk when conducting an audit.**

3. "Materiality" is defined in the Accounting Standards Council's "Framework for the Preparation and Presentation of Financial Statements" 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."

Materiality

4. **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 identified financial reporting framework.** The assessment of what is material is a matter of professional judgment.

5. In designing the audit plan, the auditor establishes an acceptable materiality level so as to detect quantitatively material misstatements. However both the amount (quantity) and nature (quality) of misstatements need to be considered. Examples of qualitative misstatements would be the inadequate or improper description of an accounting policy when it is likely that a user of the financial statements would be misled by the description, and failure to disclose the breach of regulatory requirements when it is likely that the consequent imposition of regulatory restrictions will significantly impair operating capability.

6. The auditor needs to consider the possibility of misstatements of relatively small amounts that, cumulatively, could have a material effect on the financial statements. 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.

7. The auditor considers materiality at both the overall financial statement level and in relation to individual account balances, classes of transactions and disclosures. Materiality may be influenced by considerations such as legal and regulatory requirements and considerations relating to individual financial statement account balances and relationships. This process may result in different materiality levels depending on the aspect of the financial statements being considered.

8. **Materiality should be considered by the auditor when:**

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

   (b) evaluating the effect of misstatements.

The Relationship Between Materiality and Audit Risk

9. When planning the audit, the auditor considers what would make the financial statements materially misstated. The auditor's assessment of materiality, related to specific account balances and classes of transactions, helps the auditor decide such questions as what items to examine and whether to use sampling and analytical procedures. This enables the auditor to select audit procedures that, in combination, can be expected to reduce audit risk to an acceptably low level.

10. There is an inverse relationship between materiality and the level of audit risk, that is, the higher the materiality level, the lower the audit risk and vice versa. The auditor takes the inverse relationship between materiality and audit risk into account when determining the nature, timing and extent of audit procedures. For example, if, after planning for specific audit procedures, the auditor determines that the acceptable materiality level is lower, 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.

Materiality and Audit Risk in Evaluating Audit Evidence

11. The auditor's assessment of materiality and audit risk may be different at the time of initially planning the engagement from at 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 actual results of operations and financial position are substantially different, the assessment of materiality and audit risk may also change. Additionally, the auditor may, in planning the audit work, intentionally set the acceptable materiality level at a lower level than is intended to be used to evaluate the results of the audit. This may be done to reduce the likelihood of undiscovered misstatements and to provide the auditor with a margin of safety when evaluating the effect of misstatements discovered during the audit.

Evaluating the Effect of Misstatements

12. **In evaluating the fair presentation of the financial statements the auditor should assess whether the aggregate of uncorrected misstatements that have been identified during the audit is material.**

13. 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; and

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

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

15. **If management refuses to adjust the financial statements and the results of extended audit procedures do not enable the auditor to conclude that the aggregate of uncorrected misstatements is not material, the auditor should consider the appropriate modification to the auditor's report in accordance with PSA 700 "The Auditor's Report on Financial Statements."**

16. If the aggregate of the uncorrected misstatements that the auditor has identified approaches the materiality level, the auditor would consider whether it is likely that undetected misstatements, when taken with aggregate uncorrected misstatements could exceed materiality level. Thus, as aggregate uncorrected misstatements approach the materiality level the auditor would consider reducing the risk by performing additional audit procedures or by requesting management to adjust the financial statements for identified misstatements.

Effective Date

17. This PSA shall be effective for audits of financial statements for periods ending on or after June 30, 2003.

Acknowledgment

18. This PSA, "Audit Materiality," is based on International Standard on Auditing (ISA) 320 of the same title issued by the International Auditing Practices Committee of the International Federation of Accountants.

19. This PSA differs from ISA 320 with respect to the deletion of the section on Public Sector Perspective included in ISA 320.

This Philippine Standard on Auditing 320 was unanimously approved on June 24, 2002 by the members of the Auditing Standards and Practices Council:

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