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Philippine Standard on Auditing 320 (Revised and Redrafted), Materiality in Planning and Performing an Audit

What is the issue?

Philippine Standard on Auditing (PSA) 320 (Revised and Redrafted) provides more specific guidance in establishing materiality in planning and performing an audit. The extant PSA 320 requirements in calculating “materiality at the overall financial statement level”, and the “materiality in relation to classes of transactions, account balances, and disclosures” did not significantly change. PSA 320 however, introduces the concept of “performance materiality” which changes the way auditors set the materiality level to be used for scoping and testing financial statement balances.

What are the changes?

PSA 320 now clearly requires the auditor to determine three different levels of materiality, as follows:

A. Materiality for the financial statements as a whole¹

Materiality for the financial statements as whole (hereinafter referred to as the “overall materiality”) is the materiality determined at the overall financial statement level. This materiality level helps the auditor determine whether the proposed audit adjustments are significant or not. If the audit adjustments exceed this level, the auditor may need to adjust the financial statements.

The following steps are required in calculating overall materiality:

1. Identify an appropriate benchmark which could either be an element or component of the financial statements (e.g. profit before tax, gross profit, revenue/sales; or it can also be total assets or total equity).
2. Choose an appropriate percentage to be applied to that benchmark.

¹ In practice, these may be referred to as “overall materiality”, “general materiality level” or “tolerable misstatement”.

In determining the appropriate benchmark, the following factors are normally considered by the auditor:

- components of the financial statements
- focus of the users of the financial statements
- nature of the entity
- ownership structure of the entity
- volatility of the benchmark identified
- laws and regulations (e.g. SEC)²

In practice, the benchmark commonly used for profit-oriented companies is profit from continuing operations before tax. However, the auditor should also take into account whether there are circumstances that give rise to an exceptional increase or decrease affecting the chosen benchmark (i.e. non-recurring gain or loss). In such case, the auditor may use a benchmark based on a normalized profit before tax from continuing operations.

B. Performance materiality³

Performance materiality is calculated as a certain percentage of overall materiality in order to capture any uncorrected misstatements, the total amount of which may exceed overall materiality. This materiality level is used in scoping of financial statement line items to be tested by the auditor and ensures that significant accounts in the financial statements are covered by audit testing.

In determining performance materiality, an understanding of the following factors may affect the auditor's judgment such as:

- nature of the entity's business and transactions
- risk assessment procedures
- nature and extent of misstatements identified in previous audits

C. Materiality applied to specific classes of transactions, account balance or disclosures⁴

Materiality applied to specific classes of transactions, account balances or disclosures (hereinafter referred to as "specific materiality") is the amount set by the auditor for particular classes of transactions, account balances or disclosures for which misstatements, well though lower than overall materiality could reasonably be expected to influence the economic decisions of users of the financial statements.

² SEC Memorandum Circular No. 8, Series 2009, "Scale of Fines for Non-compliance with the Financial Reporting Requirements of the Commission", considers significant accounts equivalent to 5% of a balance sheet or income statement line item for listed companies, mutual funds, other issuers of securities to public and pre-need companies. For all other corporations, the threshold shall be 10% or more.

³ In practice, these may be referred to as "planning materiality" or "scoping materiality".

⁴ In practice, these may be referred to as "specific materiality" or "individual materiality".

In determining the specific materiality, the auditor normally considers the following factors:

- laws and regulations (e.g. related party transactions)⁵
- financial reporting framework
- key industry disclosures of the entity
- particular aspects of the entity's business
- understanding of the view of those charged with governance and management

Revisions to initial materiality levels

If the auditor becomes aware of information during the audit that would have caused the determination of a different amount of the benchmark, the auditor should revise the overall materiality and the auditor should assess the need to revise performance materiality and specific materiality, and whether the nature, timing and extent of further audit procedures remain appropriate.

Documentation requirements

PSA 320, paragraph 4 states that the auditor is required to include in the audit documentation the amounts and the factors considered in the determination of the materiality levels prescribed by this standard including the basis for any revisions to those materiality levels. Audit documentation should demonstrate the judgment and rationale used by the auditor in determining these materiality levels.

Illustrative examples to apply PSA 320 requirements

The illustrative examples and the percentages used below are only for illustration purposes, and do not in any way provide guidance or to be used as a standard practice. The auditor should use his/her professional judgment in setting and determining the materiality levels in an audit of financial statements.

For illustration purposes, consider the following financial information of an entity:

Total assets	P 1,000,000
Total liabilities	700,000
Total equity	300,000
Sales	P 800,000
Cost of sales	600,000
Gross profit	200,000
Operating expenses	50,000
Profit before tax	150,000
Income tax provision	45,000
Profit for the year	P 105,000

⁵ SEC Memorandum Circular No. 8, Series of 2009, states that related party transactions as required under PAS 24, Related Party Transactions, are considered significant regardless of amount involved if the company is a public company, a listed companies, issuers of securities to public or secondary licensee of the SEC.

1) Overall materiality

Assuming that the entity is a profit-oriented company, the materiality levels which the auditor may consider are as follows:

	Consideration	
	Profit before tax	Sales
Benchmark	P 150,000	P 800,000
Percentage	5%	1%
Overall materiality	P 7,500	P 8,000

The above amounts are the assessment of materiality on the financial statements as a whole. They also serve as a basis in determining if identified uncorrected misstatements are already material in the aggregate to the financial statements and therefore required to be adjusted.

Although the above amounts are acceptable, appropriate overall materiality will depend on the factors (PSA 320.3A) considered in determining the correct benchmark.

2) Performance materiality

Based on the above overall materiality levels, the auditor may consider the overall engagement risk and the history of booked audit adjustments in determining the percentage for performance materiality.

Assuming based on the auditor's judgment, the following rationale and percentages have been determined:

	Rationale for higher performance materiality	Rationale for lower performance materiality
Overall engagement risk	Low	High
History of booked audit adjustment	Limited to none	Frequent
Fraud risk	Low	High
Threshold to adopt based on professional judgment and understanding of the entity	25% lower than overall materiality	50% lower than overall materiality

The performance materiality is calculated as follows:

	Profit before tax	Sales
Overall materiality	P 7,500	P 8,000
Performance materiality		
Higher (25%)	P 5,625	P 6,000
Lower (50%)	P 3,750	P 4,000

As calculated above, all financial statement line items above performance materiality are required to be included in the scope of the audit. This means that for a high risk audit engagement, a lower level of performance materiality is appropriate in order to respond to a higher risk of material misstatement. Conversely, for a low risk audit engagement, a higher level of performance materiality is appropriate as there is a lower risk of materiality misstatement.

However, it is not appropriate to automatically exclude all balances below the performance materiality level from the audit testing. The auditor should ensure that the total amount of the excluded financial statement line items should not be above overall materiality. Otherwise, the auditor should design audit procedures to reduce the total amount of excluded financial statement line items below overall materiality.

3) Specific materiality

Assume further that the auditor has assessed that there are specific users who expect a lesser level of misstatement in management compensation; the auditor may consider setting a specific materiality lower than performance materiality in order to obtain higher comfort on the audit procedures performed over management compensation. Assuming that based on the auditor's assessment, adopting a 50% threshold below performance materiality is appropriate to address the risk, the specific materiality will be computed as follows:

	Profit before tax	Sales
Specific materiality		
Higher (50% of performance materiality)	P 2,813	P 3,000
Lower (50% of performance materiality)	P 1,875	P 2,000

What do we need to do?

PSA 320 (Revised and Redrafted) is effective for audits of financial statements for periods beginning on or after December 15, 2009. Auditors therefore, should familiarize themselves with the detailed requirements of PSA 320 and evaluate the effects of the revised standard on their audits of financial statements. Auditors should consider the revised requirements on materiality to determine whether there is a need to revisit their audit methodologies to ensure compliance with the new requirements of PSA 320.

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The principles and requirements set out in this bulletin follow the applicable provisions under PSA 320 (Revised and Redrafted), Materiality in Planning and Performing an Audit which can be accessed at <http://www.aasc.org.ph/downloads/PSA/PSA.php>. This AASC Bulletin is not a substitute to reading the standard.

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