

AU-C Section 320

Materiality in Planning and Performing an Audit

Source: SAS No. 122; SAS No. 134; SAS No. 138.

Effective for audits of financial statements for periods ending on or after December 15, 2012, unless otherwise indicated.

Introduction

Scope of This Section

.01 This section addresses the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements. Section 450, *Evaluation of Misstatements Identified During the Audit*, explains how materiality is applied in evaluating the effect of identified misstatements on the audit and the effect of uncorrected misstatements, if any, on the financial statements.

Materiality in the Context of an Audit

.02 Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and fair presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that

- misstatements, including omissions, are considered to be material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements.
- judgments about materiality are made in light of surrounding circumstances and are affected by the size or nature of a misstatement, or a combination of both.
- judgments about materiality involve both qualitative and quantitative considerations.
- judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

[As amended, effective for audits of financial statements for periods ending on or after December 15, 2021, by SAS No. 138.]

.03 Such a discussion about materiality provides a frame of reference to the auditor in determining materiality for the audit. If the applicable financial reporting framework does not include a discussion of the concept of materiality, the characteristics referred to in paragraph .02 provide the auditor with such a frame of reference.

.04 The auditor's determination of materiality is a matter of professional judgment and is affected by the auditor's perception of the financial information needs of users of the financial statements. For purposes of determining materiality, the auditor may assume that reasonable users

- a. have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;
- b. understand that financial statements are prepared, presented, and audited to levels of materiality;
- c. recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment, and the consideration of future events; and
- d. make reasonable judgments based on the information in the financial statements.

[As amended, effective for audits of financial statements for periods ending on or after December 15, 2021, by SAS No. 138.]

.05 The concept of materiality is applied by the auditor both in planning and performing the audit; evaluating the effect of identified misstatements on the audit and the effect of uncorrected misstatements, if any, on the financial statements; and in forming the opinion in the auditor's report. (Ref: par. .A2)

.06 In planning the audit, the auditor makes judgments about misstatements that will be considered material. These judgments provide a basis for

- a. determining the nature and extent of risk assessment procedures;
- b. identifying and assessing the risks of material misstatement; and
- c. determining the nature, timing, and extent of further audit procedures.

The materiality determined when planning the audit does not necessarily establish an amount below which uncorrected misstatements, individually or in the aggregate, will always be evaluated as immaterial. The circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are below materiality. It is not practicable to design audit procedures to detect all misstatements that could be material solely because of their nature (that is, qualitative considerations). However, consideration of the nature of potential misstatements in disclosures is relevant to the design of audit procedures to address risks of material misstatement.¹ In addition, when evaluating the effect on the financial statements of all uncorrected misstatements, the auditor considers not only the size but also the nature of uncorrected misstatements, and the particular circumstances of their occurrence.² (Ref: par. .A1) [As amended, effective for audits of financial statements for periods ending on or after December 15, 2021, by SAS No. 134.]

Effective Date

.07 This section is effective for audits of financial statements for periods ending on or after December 15, 2012.

¹ See paragraphs .A141–.A142 of section 315, *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement*. [Footnote added, effective for audits of financial statements for periods ending on or after December 15, 2021, by SAS No. 134.]

² Paragraph .A23 of section 450, *Evaluation of Misstatements Identified During the Audit*. [Footnote renumbered by the issuance of SAS No. 134, May 2019.]

Objective

.08 The objective of the auditor is to apply the concept of materiality appropriately in planning and performing the audit.

Definition

.09 For purposes of generally accepted auditing standards (GAAS), the following term has the meaning attributed as follows:

Performance materiality. The amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, *performance materiality* also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances, or disclosures. Performance materiality is to be distinguished from tolerable misstatement. (Ref: par. .A3)

Requirements

Determining Materiality and Performance Materiality When Planning the Audit

.10 When establishing the overall audit strategy, the auditor should determine materiality for the financial statements as a whole. If, in the specific circumstances of the entity, one or more particular classes of transactions, account balances, or disclosures exist for which there is a substantial likelihood that misstatements of lesser amounts than materiality for the financial statements as a whole would influence the judgment made by a reasonable user based on the financial statements, the auditor also should determine the materiality level or levels to be applied to those particular classes of transactions, account balances, or disclosures. (Ref: par. .A4–.A14) [As amended, effective for audits of financial statements for periods ending on or after December 15, 2021, by SAS No. 138.]

.11 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. (Ref: par. .A15)

Revision as the Audit Progresses

.12 The auditor should revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances, or disclosures) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially. (Ref: par. .A16–.A17)

.13 If the auditor concludes that a lower materiality than that initially determined for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances, or disclosures) is appropriate, the auditor should determine whether it is necessary to revise performance materiality and whether the nature, timing, and extent of the further audit procedures remain appropriate.

Documentation

.14 The auditor should include in the audit documentation the following amounts and the factors considered in their determination:³

- a. Materiality for the financial statements as a whole (see paragraph .10)
- b. If applicable, the materiality level or levels for particular classes of transactions, account balances, or disclosures (see paragraph .10)
- c. Performance materiality (see paragraph .11)
- d. Any revision of (a)–(c) as the audit progressed (see paragraphs .12–.13)

Application and Other Explanatory Material

Materiality in the Context of an Audit (Ref: par. .06)

.A1 Identifying and assessing the risks of material misstatement⁴ involves the use of professional judgment to identify those classes of transactions, account balances, and disclosures, including qualitative disclosures, the misstatement of which could be material (in general, misstatements are considered to be material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements). When considering whether misstatements in qualitative disclosures could be material, the auditor may identify relevant factors such as the following:

- The circumstances of the entity for the period (For example, the entity may have undertaken a significant business combination during the period.)
- The applicable financial reporting framework, including changes therein (For example, a new financial reporting standard may require new qualitative disclosures that are significant to the entity.)
- Qualitative disclosures that are important to users of the financial statements because of the nature of an entity (For example, liquidity risk disclosures may be important to users of the financial statements for a financial institution.)

[Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 2021, by SAS No. 134. Revised, April 2020, to reflect conforming changes necessary due to the issuance of SAS No. 138.]

Materiality and Audit Risk (Ref: par. .05)

.A2 In conducting an audit of financial statements, the overall objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether

³ Paragraphs .08–.12 and .A8 of section 230, *Audit Documentation*. [Footnote renumbered by the issuance of SAS No. 134, May 2019.]

⁴ Paragraph .26 of section 315 requires the auditor to identify and assess the risk of material misstatement at the financial statement and assertion levels. [Footnote added, effective for audits of financial statements for periods ending on or after December 15, 2021, by SAS No. 134.]

the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework and to report on the financial statements and communicate, as required by GAAS, in accordance with the auditor's findings.⁵ The auditor obtains reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level.⁶ *Audit risk* is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk.⁷ Materiality and audit risk are considered throughout the audit, in particular, when

- a. determining the nature and extent of risk assessment procedures to be performed;
- b. identifying and assessing the risks of material misstatement;⁸
- c. determining the nature, timing, and extent of further audit procedures;⁹ and
- d. evaluating the effect of uncorrected misstatements, if any, on the financial statements¹⁰ and in forming the opinion in the auditor's report.

[Paragraph renumbered by the issuance of SAS No. 134, May 2019.]

Definition (Ref: par. .09)

.A3 *Tolerable misstatement* is the application of performance materiality to a particular sampling procedure. Section 530, *Audit Sampling*, defines *tolerable misstatement* and provides further application guidance about the concept.¹¹ [Paragraph renumbered by the issuance of SAS No. 134, May 2019.]

Determining Materiality and Performance Materiality When Planning the Audit

Considerations Specific to Governmental Entities (Ref: par. .10)

.A4 In the case of a governmental entity, legislators and regulators are often the primary users of its financial statements. Furthermore, the financial statements may be used to make decisions other than economic decisions. The determination of materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances, or disclosures) in an audit of the financial statements of a governmental entity, therefore, may be influenced by law or regulation. [Paragraph renumbered by the issuance of SAS No. 134, May 2019.]

.A5 For most state or local governments, a governmental entity's applicable financial reporting framework is based on multiple reporting units, and

⁵ Paragraph .12 of section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*. [Footnote renumbered by the issuance of SAS No. 134, May 2019.]

⁶ Paragraph .19 of section 200. [Footnote renumbered by the issuance of SAS No. 134, May 2019.]

⁷ Paragraph .14 of section 200. [Footnote renumbered by the issuance of SAS No. 134, May 2019.]

⁸ See section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. [Footnote renumbered by the issuance of SAS No. 134, May 2019.]

⁹ See section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*. [Footnote renumbered by the issuance of SAS No. 134, May 2019.]

¹⁰ Paragraph .11 of section 450. [Footnote renumbered by the issuance of SAS No. 134, May 2019.]

¹¹ Paragraph .A6 of section 530, *Audit Sampling*. [Footnote renumbered by the issuance of SAS No. 134, May 2019.]

generally, the auditor expresses or disclaims an opinion on a government's financial statements as a whole by providing opinions or disclaimers of opinion on each opinion unit. That is, a state or local governmental entity's applicable financial reporting framework requires the presentation of financial statements for its varied activities in various reporting units. Consequently, a reporting unit, or aggregation of reporting units, of the governmental entity represents an opinion unit to the auditor. Accordingly, in these cases, materiality is established for each opinion unit. [Paragraph renumbered by the issuance of SAS No. 134, May 2019.]

Use of Benchmarks in Determining Materiality for the Financial Statements as a Whole (Ref: par. .10)

.A6 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 financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following:

- The elements of the financial statements (for example, assets, liabilities, equity, revenue, or expenses)
- Whether items exist on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance, users may tend to focus on profit, revenue, or net assets)
- 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 (for example, 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)
- The relative volatility of the benchmark

[Paragraph renumbered by the issuance of SAS No. 134, May 2019.]

.A7 Examples of benchmarks that may be appropriate, depending on the circumstances of the entity, include categories of reported income, such as profit before tax, total revenue, gross profit, and total expenses; total equity; or net asset value. Profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues. [Paragraph renumbered by the issuance of SAS No. 134, May 2019.]

.A8 With regard to the chosen benchmark, relevant financial data ordinarily includes prior periods' financial results and financial positions; the period-to-date financial results and financial position, budgets, or forecasts for the current period, adjusted for significant changes in the circumstances of the entity (for example, a significant business acquisition); and relevant changes of conditions in the industry or economic environment in which the entity operates. For example, when, as a starting point, materiality for the financial statements as a whole is determined for a particular entity based on a percentage of profit before tax from continuing operations, circumstances that give rise to an exceptional decrease or increase in such profit may lead the auditor to conclude that materiality for the financial statements as a whole is more appropriately determined using a normalized profit before tax from continuing operations figure

based on past results. [Paragraph renumbered by the issuance of SAS No. 134, May 2019.]

.A9 Materiality relates to the financial statements that are being audited. When the financial statements are prepared for a financial reporting period of more or less than 12 months, such as may be the case for a new entity or a change in the financial reporting period, materiality relates to the financial statements prepared for that financial reporting period. [Paragraph renumbered by the issuance of SAS No. 134, May 2019.]

.A10 Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment. A relationship exists between the percentage and the chosen benchmark, such that a percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue. For example, the auditor may consider a percentage of profit before tax from continuing operations to be appropriate for a profit-oriented entity in a manufacturing industry. Chapter 3 of the AICPA Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* provides further guidance about the use of benchmarks in determining materiality. [Paragraph renumbered by the issuance of SAS No. 134, May 2019.]

Considerations Specific to Smaller, Less Complex Entities

.A11 When an entity's profit before tax from continuing operations is consistently nominal, which might be the case for an owner-managed business in which the owner takes much of the profit before tax in the form of remuneration, a benchmark such as profit before remuneration and tax may be more relevant. [Paragraph renumbered by the issuance of SAS No. 134, May 2019.]

Considerations Specific to Governmental Entities

.A12 In an audit of a governmental entity, total cost or net cost (expenses less revenues or expenditures less receipts) may be appropriate benchmarks for program activities. When a governmental entity has custody of public assets, assets may be an appropriate benchmark. [Paragraph renumbered by the issuance of SAS No. 134, May 2019.]

Materiality Level or Levels for Particular Classes of Transactions, Account Balances, or Disclosures (Ref: par. .10)

.A13 Factors that may indicate the existence of one or more particular classes of transactions, account balances, or disclosures for which there is a substantial likelihood that misstatements of lesser amounts than materiality for the financial statements as a whole would influence the judgment made by a reasonable user based on the financial statements include the following:

- Whether law, regulation, or the applicable financial reporting framework affect users' expectations regarding the measurement or disclosure of certain items (for example, related party transactions and the remuneration of management and those charged with governance, and sensitivity analysis for fair value accounting estimates with high estimation uncertainty)
- The key disclosures with regard to the industry in which the entity operates (for example, research and development costs for a pharmaceutical company)
- Whether attention is focused on a particular aspect of the entity's business that is separately disclosed in the financial statements

(for example, disclosures about discontinued operations or a significant business combination)

[Paragraph renumbered and amended, effective for audits of financial statements for periods ending on or after December 15, 2021, by SAS No. 134. As amended, effective for audits of financial statements for periods ending on or after December 15, 2021, by SAS No. 138.]

.A14 In considering whether, in the specific circumstances of the entity, such classes of transactions, account balances, or disclosures exist, the auditor may find it useful to obtain an understanding of the views and expectations of those charged with governance and management. [Paragraph renumbered by the issuance of SAS No. 134, May 2019.]

Performance Materiality (Ref: par. .11)

.A15 Planning the audit solely to detect individual material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and leaves no margin for possible undetected misstatements. *Performance materiality* (which, as defined, is one or more amounts) is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole. Similarly, performance materiality relating to a materiality level determined for a particular class of transactions, account balance, or disclosure is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in that particular class of transactions, account balance, or disclosure exceeds the materiality level for that particular class of transactions, account balance, or disclosure. The determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by the auditor's understanding of the entity, updated during the performance of the risk assessment procedures, and the nature and extent of misstatements identified in previous audits and, thereby, the auditor's expectations regarding misstatements in the current period. [Paragraph renumbered by the issuance of SAS No. 134, May 2019.]

Revision as the Audit Progresses (Ref: par. .12)

.A16 In some situations, the auditor may determine materiality for planning purposes before the financial statements to be audited are prepared. In those situations, the auditor's professional judgment about materiality might be based on the entity's annualized interim financial statements or financial statements of one or more prior annual periods. If it appears as though the actual financial results are likely to be substantially different from the anticipated results, such as when there are major changes in the entity's circumstances (for example, a significant merger) or relevant changes in the economy as a whole or the industry in which the entity operates, the auditor may be required, in accordance with paragraph .12, to revise materiality. [Paragraph renumbered by the issuance of SAS No. 134, May 2019.]

.A17 Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances, or disclosures) may need to be revised as a result of a change in circumstances that occurred during the audit (for example, a decision to dispose of a major part of the entity's business), new information, or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures. For example, if, during the audit, it appears as though

actual financial results are likely to be substantially different from the anticipated period-end financial results that were used initially to determine materiality for the financial statements as a whole, the auditor may be required, in accordance with paragraph .12, to revise materiality. [Paragraph renumbered by the issuance of SAS No. 134, May 2019.]
