KAEG-I [INTL VERSION 2024]: ISA 320 Materiality in Planning and Performing an Audit

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ISA 320 Materiality in Planning and Performing an Audit

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ISA 320 *Materiality in Planning and Performing an Audit*

(Effective for audits of financial statements for periods beginning on or after December 15, 2009)

International Standard on Auditing (ISA) 320, *Materiality in Planning and Performing an Audit*, should be read in the context of ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing.*

Introduction, Objective and Definition

International Standards on Auditing: ISA 320.01-09

Introduction

Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements. ISA 450[1] explains how materiality is applied in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements.

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1 ISA 450, *Evaluation of Misstatements Identified during the Audit*

Materiality in the Context of an Audit

2. Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and 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 they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of 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; and
- 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.[2] The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

2 For example, the *Framework for the Preparation and Presentation of Financial Statements*, adopted by the International Accounting Standards Board in April 2001, indicates that, for a profit-oriented entity, as investors are providers of risk capital to the enterprise, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy.

3. Such a discussion, if present in the applicable financial reporting framework, 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 2 provide the auditor with such a frame of reference.

4. 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. In this context, it is reasonable for the auditor to assume that 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 economic decisions on the basis of the information in the financial statements.

5. The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report. (Ref: Para. A1)

6. 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, timing 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. However, consideration of the nature of potential misstatements in disclosures is relevant to the design of audit procedures to address risks of material misstatement.[3] 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.[4] (Ref: Para. A2)

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3 See ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment*, paragraphs A134-A135.

4 ISA 450, paragraph A21

Effective Date

7. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2009.

Objective

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

Definition

9. For purposes of the ISAs, the following terms have the meanings attributed below:

(a) Performance materiality - The amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce aggregation risk to an appropriately low level. 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.

(b) Aggregation risk - The probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statement as a whole.

ISA Application and Other Explanatory Material: ISA 320.A1-A2

Application and Other Explanatory Material

Materiality and Audit Risk (Ref: Para. 5)

A1. 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 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 the ISAs, in accordance with the auditor's findings.[6] The auditor obtains reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level.[7] 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.[8] Materiality and audit risk are considered throughout the audit, in particular, when:

(a) Identifying and assessing the risks of material misstatement;[9]

(b) Determining the nature, timing and extent of further audit procedures;[10] and

(c) Evaluating the effect of uncorrected misstatements, if any, on the financial statements[11] and in forming the opinion in the auditor's report.[12]

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6 ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing,* paragraph 11

7 ISA 200, paragraph 17

8 ISA 200, paragraph 13(c)

9 ISA 315 (Revised)

10 ISA 330, *The Auditor's Responses to Assessed Risks*

11 ISA 450

12 ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*

Materiality in the Context of an Audit (Ref: Para. 6)

A2. Identifying and assessing the risks of material misstatement[13] 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 (i.e., in general, misstatements are considered to be material if they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements as a whole). When considering whether misstatements in qualitative disclosures could be material, the auditor may identify relevant factors such as:

- 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).

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13 ISA 315 (Revised), paragraph 25, requires the auditor to identify and assess the risk of material misstatement at the financial statement and assertion level

Determining Materiality When Planning the Audit

International Standards on Auditing: ISA 320.10

Requirements

Determining Materiality and Performance Materiality When Planning the Audit

10. When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures. (Ref: Para. A3-A12)

ISA Application and Other Explanatory Material: ISA 320.A3-A12

Determining Materiality and Performance Materiality When Planning the Audit

Considerations Specific to Public Sector Entities (Ref: Para. 10)

A3. In the case of a public sector 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 public sector entity is therefore influenced by law, regulation or other authority, and by the financial information needs of legislators and the public in relation to public sector programs.

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

A4. 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, expenses);
- Whether there are items 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); and
- The relative volatility of the benchmark.

A5. 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.

A6. In relation 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, and 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.

A7. Materiality relates to the financial statements on which the auditor is reporting. Where the financial statements are prepared for a financial reporting period of more or less than twelve 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.

A8. Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment. There is a relationship 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 five percent of profit before tax from continuing operations to be appropriate for a profit-oriented entity in a manufacturing industry, while the auditor may consider one percent of total revenue or total expenses to be appropriate for a not-for-profit entity. Higher or lower percentages, however, may be deemed appropriate in the circumstances.

Considerations Specific to Small Entities

A9. When an entity's profit before tax from continuing operations is consistently nominal, as might be the case for an owner-managed business where 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.

Considerations Specific to Public Sector Entities

A10. In an audit of a public sector entity, total cost or net cost (expenses less revenues or expenditure less receipts) may be appropriate benchmarks for program activities. Where a public sector entity has custody of public assets, assets may be an appropriate benchmark.

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

A11. Factors that may indicate the existence of one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of 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, the remuneration of management and those charged with governance, and sensitivity analysis for fair value accounting estimates with high estimation uncertainty).
- The key disclosures in relation 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 segments or a significant business combination).

A12. 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.

How do we comply with the Standards?

[ISA | KAEGHDWC]

1 Establish materiality for the financial statements as a whole [ISA | 923]

What do we do?

Establish materiality for the financial statements as a whole

Why do we do this?

Establishing materiality enables us to:

- plan and perform our audit;
- evaluate the results of the audit; and
- ultimately, form an opinion on the financial statements.

Setting an appropriate materiality helps us to gain sufficient appropriate audit evidence to support our audit opinion.

Execute the Audit

What is materiality? [ISA | 923.1300]

Materiality is the amount we believe will be material to the users of the financial statements. The auditing standards explain what is 'material' in an audit.

What is 'material' to the users of the financial statements? [ISA | 923.11495]

'Material' to the users of the financial statements is information that could reasonably be expected to lead users to make a different judgment (also referred to as an economic decision) about doing business with or investing in the entity.

Who are the users we consider when establishing materiality? [ISA | 923.11496]

The users are a group that relies on the accuracy of the financial statements we audit to make judgments.

Users may include:

- existing and potential investors
- lenders and other creditors
- legislators and regulators

We do not consider every user individually, but rather as a group.

We assume the users:

- 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;
- understand that financial statements are prepared, presented and audited to levels of materiality;
- recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and

- make reasonable judgments on the basis of all information in the financial statements.

For a publicly traded company or listed entity, we also refer to this group of users as the 'reasonable investor'.

Can something be qualitatively material even if it does not exceed our established materiality? [ISA | 923.11497]

Yes, something could be considered material even though it is less than our established materiality amount.

We consider both qualitative and quantitative factors when we decide whether something is material. For example, when we evaluate misstatements, we consider factors like whether the misstatement relates to fraud or an illegal act.

What do we mean by 'the financial statements as a whole'? [ISA | 923.1400]

When we establish materiality for 'the financial statements as a whole', we mean that we consider *all* of the financial statements, including the footnotes — not just a particular statement or set of accounts.

And while we focus on metrics that might be most important to users in establishing materiality, we consider those metrics in the context of all the financial statements, including the footnotes.

How do we establish materiality for the financial statements as a whole? [ISA | 923.11498]

We establish materiality by considering the collective needs of the users. Establishing materiality is not a calculation but rather a matter of professional judgment.

To establish materiality, we follow these steps:

(1) Identify the relevant metrics, including the benchmark
(2) Determine the amounts of the relevant metrics, including the benchmark
(3) Establish materiality as a specified amount
(4) Consult with DPP in certain circumstances

Do we use these steps to establish materiality when the entity operates in an environment where a regulator requires, or has established views, on what an appropriate amount of materiality is? [ISA | 923.11499]

Yes, we use the same steps to establish materiality. In certain industries or countries, a regulator may have expressed views on materiality, including the appropriate benchmark and even a specific percentage of that benchmark.

In many cases, we expect that the regulator's view will be the ultimate outcome, but we still follow each of the steps and use the regulator's view as an amount that we would not exceed. We do not simply default to their view.

Group Audit | How do we establish materiality for a group audit? [ISA | 923.159838]

As the group auditor, we establish group materiality in the same way as in a stand-alone audit, but consider the amounts of metrics from the consolidated financial statements.

Is there industry-specific guidance that we consider when establishing materiality? [ISA | 923.11534]

Yes, for certain industries, there may be additional materiality guidance issued by KPMG member firms that supplements the KPMG Audit Execution Guide. In those instances when that industry-specific materiality guidance applies, we consider the applicability of that guidance.

How do we establish materiality when we are auditing a period that is more or less than 12 months? [ISA | 923.11501]

When we are auditing a period that is more or less than 12 months, we still issue an opinion on the financial statements as a whole, which contain the same financial statements and disclosures as a 12 month period. As such, we follow the same steps to establish materiality and use the amounts that relate to the financial statements prepared for that financial reporting period.

Can we establish a different materiality for each financial statement (e.g. balance sheet, income statement) presented? [ISA | 923.1700]

No. We establish one value representing materiality for the financial statements as a whole that considers the complete set of financial statements - e.g. a balance sheet, income statement, statement of cash flows, footnote disclosures. We do not establish one materiality amount for the income statement and a different one for the balance sheet.

However, we may identify particular accounts or disclosures where misstatements that are less than materiality could be considered quantitatively material. In these instances, we establish a lower materiality (see activity 'Determine whether to establish a lower materiality for particular accounts or disclosures for further information').

Group Audit | How do we determine group materiality for stand-alone parent entity financial statements, where investments in subsidiaries are accounted for using the equity method? [ISA | 923.159613]

To determine the amounts of the metrics used to determine group materiality, we use the amounts of the metrics as if the subsidiaries had been fully consolidated rather than the actual amounts reported in the stand-alone parent entity financial statements

1.1 Identify the relevant metrics, including the benchmark [ISA | 924]

What do we do?

Identify the relevant metrics, including the benchmark

Why do we do this?

Since our audit opinion will support the judgments of financial statement users, we determine the metrics which could be relevant to them when setting materiality.

Execute the Audit

How do we identify the relevant metrics, including the benchmark? [ISA | 924.1300]

To identify the relevant metrics, including the benchmark, we:

(1) Identify the relevant metrics - The metrics in the financial statements that are important to the users.
(2) Determine the benchmark - The relevant metric that most influences the judgments of the users.

1.1.1 Identify the relevant metrics [ISA | 925]

What do we do?

Identify the metrics that are important to financial statement users AND if applicable, document our rationale for excluding any of the presumed metrics in the Metrics and Benchmark Table (MBT)

Why do we do this?

In order to determine what will be material to the users of the financial statements, the first step in establishing materiality is to identify the relevant metrics that are important to the users of the financial statements.

Execute the Audit

What are metrics in the context of establishing materiality? [ISA | 925.11817]

Metrics are measurable elements of the financial statements or measures derived from elements of the financial statements). Metrics can be either gross or net metrics.

What is a gross metric when establishing materiality? [ISA | 925.11821]

A gross metric is an individual financial caption, or a summary of financial captions of similar balances (i.e. debit or credit balances), that is not reduced by other financial statement captions. Examples of gross metrics include total revenue, total assets, and total expenses.

An exception to this is net revenue. Net revenue consists of some deductions to revenue - e.g., sales returns - that may or may not appear as separate financial captions, but it is still be considered a gross metric.

Net assets/equity is neither a gross nor a net metric for the purpose of establishing materiality.

What is a net metric when establishing materiality? [ISA | 925.11861]

A net metric will consist of financial statement captions that both are added and subtracted from one another to arrive at a net amount — e.g. PBTCO.

Net assets/equity is neither a gross nor a net metric for the purpose of establishing materiality.

What are relevant metrics for establishing materiality? [ISA | 925.11862]

'Relevant' metrics are those which are important to the users based on our understanding of how they use the financial statements (see questions - 'Who are the users we consider when establishing materiality?').

How do we identify the relevant metrics when establishing materiality? [ISA | 925.11822]

We think about what is important to the users, as well as consider the presumed metrics in the MBT.

How do we think about what is important to the users? [ISA | 925.11823]

We think about the following considerations that can help us determine what is important to the users:

- the nature of the entity (e.g. profit-seeking, not-for-profit, public sector);
- where it is in its life cycle (e.g. starting-up, growing, maturing, declining);
- the industry and economic environment in which the entity operates;
- the entity's ownership structure and the way it is financed;
- the elements of the financial statements; and
- whether there are particular items upon which users tend to focus.

Below are examples of how these consideration may indicate what is important to the users:

Consideration	What is important to the users?	Example of a metric that may be relevant
Profit-seeking entity	The entity's profitability and prospects for future net cash inflows.	PBTCO
A highly leveraged entity	The entity's ability to service its debt, including the ability to satisfy obligations and comply with debt covenants and continue as a going concern.	Net Assets
An entity in an industry where margins can fluctuate significantly	The sales base that would drive future profitability and cash flows.	Total Revenues
An entity primarily generating profit from lending activities	The asset base that drives lending activities - i.e. the primary profit-generating activities.	Total Assets

Where may we obtain information to determine what is important to users? [ISA | 925.11824]

Examples of where we may obtain information include:

- internal financial reporting information, including management reports
- minutes of meetings of shareholders, board of directors and board committees
- budgets and long-term entity strategy presentations to the board of directors and those charged with governance
- debt and other contractual agreements
- management compensation agreements
- industry reports
- the entity's website and press releases
- news articles about the entity or generally about its industry
- information presented at industry conferences

- industry and external analyst reports
- government laws and regulations.

What is important to the users of financial statements for pension plans? [ISA | 925.11825]

Under a defined benefit plan, the payment of promised retirement benefits is important to the users and depends on:

- the financial position of the plan
- the ability of contributors to make future contributions to the plan and
- investment performance and operating efficiency of the plan.

The objective of reporting by a defined benefit plan is periodically to provide information about the financial resources and activities of the plan that is useful in assessing the relationships between the accumulation of resources and plan benefits over time.

Under a defined contribution plan, the amount of a participant's future benefits is important to the users and is determined by:

- the contributions paid by the employer,
- the contributions paid by participant and
- the operating efficiency and investment earnings of the fund.

The participants are likely to be interested in the activities of the plan, because they directly affect the level of their future benefits.

What is the Metrics and Benchmark Table? [ISA | 925.11863]

The Metrics and Benchmark Table (MBT) includes the presumed metrics and benchmark for entities with certain characteristics or operating in certain industries.

The metrics in the MBT do not replace our consideration of relevant metrics, including the benchmark, as we think about users of the financial statements. Rather, we use the MBT as a tool to help better inform our consideration of relevant metrics, including the benchmark.

What is the MBT for profit-seeking entities? [ISA | 925.11826]

The MBT for profit-seeking entities is presented below. The metric noted with an * is the presumed benchmark.

Industry	Presumed metrics and benchmark	Notes
General	PBTCO/LBTCO* Total revenue Total assets	
Banks	PBTCO/LBTCO* Total revenue Total assets Net assets	Banks generally have high values for total assets and liabilities relative to PBTCO. While PBTCO is likely

		to be the appropriate benchmark, total assets is also an important metric, as users likely focus on it given its size and importance to the business.
Insurance	PBTCO/LBTCO* Total revenue Total assets Net assets	Insurers generally have high values for total assets and liabilities relative to PBTCO. While PBTCO is likely to be the appropriate benchmark, total assets is also important metric, as users likely focus on it given its size and importance to the business.
Industries that have "significant assets", e.g. Mining, Airlines	PBTCO/LBTCO* Total revenue Total assets	While PBTCO is likely to be the appropriate benchmark, total assets is likely to be an important metric, as users likely focus on it given its size and importance to the business.
Investment Funds/Trusts	PBTCO/LBTCO Total revenue Total assets* Net assets	
Entities that trade mainly for capital gain, e.g. Property Investment	PBTCO/LBTCO Total assets*	Asset value is likely the primary focus of users in these entities because "profit" is

		generated through increases in the value of the underlying assets.

What is the Metrics and Benchmark Table for other scenarios for profit-seeking entities? [ISA | 925.1710]

The MBT for other scenarios for profit-seeking entities is presented below. The metric noted with an * is the presumed benchmark.

Scenario	Presumed metrics and benchmark	Notes
Start-up entities predominantly focused on asset development/capital expenditure	PBTCO/LBTCO Total Assets* Total Expense	
Start-up entities not predominantly focused on asset development/capital expenditure	PBTCO/LBTCO Total Assets Total Expense*	
Entities operating at or near break-even, such that PBTCO no longer usefully serves as the benchmark	PBTCO/LBTCO Total Revenues* Total Assets	Using PBTCO/LBTCO would likely result in an inappropriately low benchmark that would not be a useful basis for determining materiality. Total revenues is likely to be the appropriate benchmark in such circumstances.
Standalone audit of a component of a group that focuses on a particular activity	Total revenues or expenses, as appropriate* Total assets	The relevant metrics for a standalone audit of a component of a group may be dependent on the structure of the group and the activities of the component. Where we are performing a standalone audit of the financial statements of a component, we may use different relevant metrics than those used at the group level, including the benchmark.

Liquidating investment funds/trusts	Total distributions*	Liquidating investment funds/ trusts are investment funds/trusts that have disposed of the vast majority of their investments in the current year (greater than 90%). Depending on the timing of distributions and nature of the investment operations of the investment fund/trust, there may be other metrics such as total revenue (e.g., investment income) that are relevant to consider when determining materiality.

What are examples of how the relevant metrics for a standalone audit of a component of a group may be dependent on the structure of the group and the activities of the component? [ISA | 925.11828]

Examples of how the relevant metrics, including the benchmark, for a standalone audit of a component are dependent on the structure of the group and the activities of the component include the following:

- A component may be set up to focus solely on sales, such that the appropriate benchmark is total revenues
- A component may be set up solely as a cost center, such that the appropriate benchmark is total expenses
- Groups are sometimes structured in a way that some components own most of the group's assets and lease the assets to other components. In such a scenario, total assets may be an appropriate metric for the component that owns the assets

What is the Metrics and Benchmark Table for pension plans? [ISA | 925.11829]

The MBT for pension plans is presented below. Metrics noted with an * is the presumed benchmark.

Industry	Presumed metrics and benchmark	Notes
Pension plans **- defined benefit plans**	Total assets* Total contributions and other income Total benefits and other expenses	Total assets is likely to be important to the users, as this is the gross amount from which members' benefits ultimately will be paid and, for defined benefit plans only, is the amount to which the actuary refers in actuarial/ funding valuations.
Pension plans	Total assets*	Total assets is likely to be of interest to the users of the

- defined contribution plans	Total contributions and other income Total benefits and other expenses	financial statements as this is the gross amount from which members' benefits ultimately will be paid.

What do 'pension plans' include? [ISA | 925.11830]

Pension plans include defined contribution pension plans and defined benefit pension plans.

Defined contribution plans are retirement benefit plans under which amounts to be paid as retirement benefits are determined by contributions to a fund together with investment earnings thereon.

Defined benefit plans are retirement benefit plans under which amounts to be paid as retirement benefits are determined by reference to a formula usually based on employees' earnings and/or years of service.

Governmental Entity or Not-for-profit Entity | What is the Metrics and Benchmark Table for not-for-profit and governmental (or public sector) entities? [ISA | 925.11831]

The MBT for not-for-profit and governmental entities is presented below. Metrics noted with an * is the presumed benchmark.

Industry	Presumed metrics and benchmark	Notes
Not-for-profits and governmental entities that generate revenue and/or incur expenses, but without a focus on profitability, e.g. museums	Total revenues or expenses, as appropriate* Total assets Program costs	Expenditures of not-for-profits and governmental entities are often tightly controlled and based on the concept of a balanced budget. Such entities often run programs with relatively small or zero operating margins. Total revenues or expenses is likely to be the appropriate benchmark, depending on which is the most appropriate for the circumstances of the entity. We may determine that total revenues or expenses is the appropriate benchmark, even when the entity has custody of significant assets, because users of the financial statements are likely to be interested in how the

		organization uses the funds that it receives.
Not-for-profits and governmental entities that have custody of assets, e.g. certain government departments	Total assets* Total expenses	Where a governmental entity has custody of public assets, total assets may be an appropriate benchmark. This is appropriate in cases where the entity has custody of assets but incurs little to no expenses to maintain the assets, and receives little to no revenues - for example, where a local government owns a court house, but the costs associated with maintaining the court house are the responsibility of the occupants.

Not-for-profit Entity | What are not-for-profit entities? [ISA | 925.11832]

Not-for-profit entities generally possess the following characteristics, in varying degrees, that distinguish them from profit-seeking entities:

- contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate financial return
- operating purposes other than to provide goods or services at a profit
- absence of ownership interests like those of business entities.

Entities that clearly fall outside this definition include the following:

- all investor-owned entities
- entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants.

Governmental Entity | What are governmental entities? [ISA | 925.11833]

Governmental entities, also known as public sector entities, refers to national governments, regional (e.g. state, provincial, territorial) governments, local (e.g. city, town) governments and related governmental entities (e.g. agencies, boards, commissions and enterprises).

Governmental entities generally have one or more of the following characteristics:

- popular election of officers or appointment (or approval) of a controlling majority of the members of the organization's governing body by officials of one or more state or local governments
- the potential for unilateral dissolution by a government with the net assets reverting to a government
- the power to enact and enforce a tax levy.

General purpose governmental entities are governmental entities that provide a range of services, such as states, cities, counties, towns, and villages.

Special purpose governmental entities are legally separate entities that perform only one activity or only a few activities. Special purpose governments may include, for example, cemetery districts, levee districts, assessment districts, drainage districts, school districts, utilities, hospitals or other health care organizations, public benefit corporations and authorities, public employee retirement systems, public colleges and universities, governmental external investment pools, and public entity risk pools.

Can we identify a relevant metric that is not included in the MBT? [ISA | 925.1900]

Absolutely. When we think about what is important to the users, we expect that we may identify relevant metrics that are not included in the MBT. The MBT is intended to be a tool that helps us identify presumed metrics, but is not intended to replace our consideration of other relevant metrics that may be important to the users.

What if we determine that a presumed metric in the MBT is not relevant to the users? [ISA | 925.11834]

If one of the presumed metrics in the MBT, other than the presumed benchmark, are not considered relevant, then we document our rationale as to why it is not relevant. If the presumed benchmark is not selected as the benchmark, we identify it as a relevant metric.

Governmental Entity or Not-for-profit Entity | When might PBTCO be a relevant metric for a not-for-profit or governmental entity? [ISA | 925.11836]

PBTCO is unlikely to be a relevant metric. However, we look beyond the legal organization of the not-for-profit or governmental entity, and determine whether it has a focus on profit. Even if the entity is a tax-exempt, not-for-profit or governmental entity, if it is has a profit focus, then PBTCO may be a relevant metric.

What do we do if a regulator requires, or has otherwise expressed, that a specific metric be used to establish materiality? [ISA | 925.1800]

In situations where a regulator requires, or has otherwise expressed, that a certain metric be used to establish materiality, we consider that metric to be relevant and may even determine that such a metric is our benchmark.

Can we consider a non-GAAP/alternative performance measure metric, such as EBITDA, when determining materiality? [ISA | 925.2500]

Yes. Often non-GAAP metrics, also known as alternative performance measures, like EBITDA are important to the users.

Similar to any other metric, we carefully consider the specific industry and circumstances of the entity to determine the relevance and importance of the non-GAAP metric. In considering the appropriateness of non-GAAP metrics, we also think about whether they are derived from and can be reconciled to amounts presented in the financial statements.

What is EBITDA? [ISA | 925.10000]

EBITDA is earnings (i.e. net income or profit) before interest, taxes, depreciation and amortization.

When management has made additional adjustments to EBITDA, that metric is referred to as 'adjusted EBITDA' and is not treated as 'EBITDA.'

Can a volatile metric be a relevant metric? [ISA | 925.11838]

Yes, a volatile metric may be a relevant metric when it is important to the users' judgments. However, users generally will not vary their consideration of what is material for an entity by significant amounts from one year to the next and using a volatile metric may impair year-to-year consistency. If a relevant metric is volatile, we adjust the metric to make it meaningful (see question - 'How do we adjust the amounts of the relevant metrics?').

What do we mean when we talk about 'volatility' in a metric? [ISA | 925.11718]

Volatility generally affects metrics from the income statement, and relates to unpredictable fluctuations that occur within a metric in a particular period.

Volatility may be inherent to the business.

> For example, a movie studio's PBTCO may be volatile from year to year depending on whether the studio has produced a blockbuster in that year.

Alternatively, an entity may have a single 'volatile' year.

> For example, an entity may have an unusual decrease in PBTCO in a year where it incurs significant expenses related to a rebranding exercise. That would be considered a volatile year if PBTCO was expected to return to 'normal' levels in the following year.

However, where changes in the entity, its industry or its environment indicate that we can expect the new levels of the relevant metrics to be permanent, those metrics are not considered volatile.

> For example, if an entity loses a customer in the current period, resulting in a significant decrease in revenues and PBTCO, which is not expected to be replaced in the following year - e.g., with a signed contract from a new customer.

1.1.2 Determine the benchmark [ISA | 926]

What do we do?

Determine the benchmark AND if applicable, document our rationale for not using the presumed benchmark in the Metrics and Benchmark Table

Why do we do this?

We determine a benchmark for three main reasons:

- to identify changes in our approach to determining materiality period-over-period,
- to help regulators and users better understand how we perform the audit (when local laws and regulations require us to disclose or communicate it), and

- to help us assess the appropriateness of our determined materiality based upon what most influences the users of the financial statements.

Execute the Audit

What is the benchmark when establishing materiality? [ISA | 926.1300]

The benchmark is the relevant metric that most influences the judgments of the users (see question - 'Who are the users we consider when establishing materiality?').

How do we determine the benchmark when establishing materiality? [ISA | 926.1400]

Determining the benchmark is a matter of auditor judgment. To determine the benchmark, we think about what is most important to the users (see question 'How do we think about what is important to the users?' for further information) and consider the presumed benchmark in the Metrics and Benchmark Table (MBT)(see question 'What is the Metrics and Benchmark Table?' for further information).

We consider the benchmark identified in the prior audit. As the benchmark is the most relevant metric, we 'expect to use the same benchmark from one period to the next. This allows us to compare our materiality as a percentage of the benchmark period-over-period, and identify significant changes (see activity 'Assess whether the materiality is appropriate in comparison to the prior audit' for further information).

If we change the benchmark from the prior audit, we document our rationale for the change.

What are examples of when it may be appropriate to change the benchmark from the prior audit? [ISA | 926.11729]

Examples of when we may change the benchmark from the prior audit include:

- The entity's life cycle has changed - for example, from starting-up to growing.
- The entity made a significant business acquisition in the current year that changed the entity's primary industry.
- The entity's costs of raw materials have continually increased year over year while revenue has remained the same such that the entity is operating at a loss
- The entity is going through a period of low profitability during a restructuring and users are now focused on sustainability and growth of revenue rather than short term profit.

What if we determine a benchmark that is different from the MBT? [ISA | 926.1900]

We document our rationale when the benchmark is not the presumed benchmark from the MBT.

Can a volatile relevant metric be our benchmark? [ISA | 926.11730]

It is possible. However, the relevant metric that most influences the users may not be an appropriate benchmark if it is volatile.

Users will not vary their consideration of what is material for an entity by significant amounts from one period to the next, and using a volatile benchmark may impair period-to-period consistency. In such situations, it may be appropriate to select a more relevant metric as the benchmark.

> For example, in situations where PBTCO is the presumed benchmark and is volatile, we may decide to choose another, more stable metric as the benchmark. If total revenues is a relevant metric and more stable than PBTCO, we may choose total revenues as the appropriate benchmark in the current period.

If we determine that that the volatile metric is still the relevant metric that most influences the users, we determine it as the benchmark and adjust it (see question - 'How do we adjust the amounts of the relevant metrics?').

What is the appropriate benchmark for entities whose "normal" profit margins are low? [ISA | 926.11731]

For entities whose "normal" profit margins are low, PBTCO is generally the appropriate benchmark. Entities whose "normal" profit margins are low are not necessarily entities for which PBTCO no longer usefully serves as the benchmark. For example, food retailers generally operate at low profit margins.

Governmental Entity or Not-for-profit Entity | When might PBTCO be an appropriate benchmark for a not-for-profit or governmental entity? [ISA | 926.11732]

Even when the entity is a tax-exempt not-for-profit or governmental entity, if it has a profit focus, the appropriate benchmark is likely to be PBTCO. We look beyond the legal organization of the entity, and determine whether it has a profit focus or not.

Governmental Entity or Not-for-profit Entity | When might total assets be the benchmark for a not-for-profit or governmental entity? [ISA | 926.11733]

Total assets may an appropriate benchmark not-for-profit or governmental entities that hold assets for the benefit of the public without related income and expenses and users of their financial statements are not interested in how the entity utilizes the funds that it receives.

What do we do if a regulator requires that we use a specific benchmark to establish materiality? [ISA | 926.11917]

We use that benchmark to establish materiality.

Can we use an alternative performance measure, such as EBITDA, as the benchmark when establishing materiality? [ISA | 926.8780]

Yes. When the metric most influences the judgments of the users, we may use it as the benchmark. In considering the appropriateness of alternative performance measure as the benchmark, we also think about whether it is derived from and can be reconciled to amounts presented in the financial statements.

What is EBITDA? [ISA | 926.10000]

EBITDA is earnings (i.e. net income or profit) before interest, taxes, depreciation and amortization.

When management has made additional adjustments to EBITDA, that metric is referred to as 'adjusted EBITDA' and is not treated as 'EBITDA.'

Is it appropriate to use LBTCO as the benchmark? [ISA | 926.6318]

It may be appropriate to use LBTCO as the benchmark when it is the metric that most influences the judgments of users and represents the entity's normal operations in line with management's strategy and business plan.

For a start-up entity that is not predominantly focused on asset development/capital expenditures, when it is appropriate not to use total expenses as the benchmark? [ISA | 926.7477]

For a start-up entity that is not predominantly focused on asset development/capital expenditure, when total recurring or core revenues are not significant, loss before tax from continuing operations (LBTCO) may be the appropriate benchmark rather than total expenses. When determining the amount of LBTCO, we consider adjusting for items that are not representative of total recurring or core revenues, such as non-recurring milestone revenue or upfront licensing payments from collaborative arrangements.

What is an example of when we may change the benchmark from the prior audit? [ISA | 926.11922]

Fact pattern:

An IT entity has been in business for five years. It develops software products and provides related implementation and maintenance services.

In prior periods, the entity focused on software development. So, it capitalized significant development costs and operating expenses, with no significant sources of revenue. Accordingly, the engagement team determined that revenue and earnings (PBTCO) were not as important to the users at this stage of the entity's life cycle.

Also, while total assets, net assets and total expenses have been important to the users, the most relevant benchmark has been total assets.

In the current period, the entity has begun to generate significant revenues in both segments but continues to operate at a loss.

Analysis:

Because the entity has begun generating significant revenues in both segments, the team determine that users' focus has shifted to total revenues, with less emphasis on total assets.

The team therefore determine that a change in the benchmark is appropriate.

1.2 Determine the amounts of the relevant metrics, including the benchmark [ISA | 928]

What do we do?

Determine the amounts of the metrics, including the benchmark

Why do we do this?

After we have identified the relevant metrics, including the benchmark, we determine the amounts to help us establish materiality as a percentage of the relevant metrics, including the benchmark.

Execute the Audit

How do we determine the amounts of the relevant metrics, including the benchmark? [ISA | 928.1400]

To determine the amounts of the relevant metrics, including the benchmark, we:

- Use preliminary or estimated amounts if final financial statement amounts are not available
- Adjust the relevant metrics, including the benchmark, when appropriate

1.2.1 Use preliminary or estimated amounts if final financial statement amounts are not available [ISA | 929]

What do we do?

IF final financial statement amounts are not available, use preliminary or estimated amounts of the relevant metrics, including the benchmark, taking into account the effects of known or expected changes in the entity's financial statements AND document the source of the amounts and how the amounts were determined.

Why do we do this?

When we establish materiality, we rarely have the final financial statement amounts due to the timing of when we establish materiality. As such, we often use either preliminary or estimated financial statement amounts when we establish materiality during planning.

Execute the Audit

What sources do we use to determine the preliminary or estimated amounts when establishing materiality? [ISA | 929.1600]

Sources of financial information we may use when establishing materiality include:

- prior periods' financial results and financial positions;
- the most recent financial information available - i.e. current period-to-date financial results and financial position;
- analyst reports, if available and historically accurate; and
- budgets or forecasts for the current period.

How do we estimate amounts when establishing materiality? [ISA | 929.11686]

We use the amounts from our source of financial information (e.g. prior periods' financial results and financial positions) as a starting point. We adjust the amounts based upon known or expected changes to this information and other specific items that may impact the amounts.

What are examples of known or expected changes that may impact the estimated amounts of relevant metrics when establishing materiality? [ISA | 929.11687]

Examples of known or expected changes that could impact the estimated amounts of the relevant metrics include:

- changes in the circumstances of the entity - e.g., a significant business acquisition, the termination or signing of a major contract, an acquisition or the loss of a key customer;
- expected or historical seasonality in the business;
- relevant changes in industry conditions or the entity's economic environment - e.g., changes in commodity prices, a macro-economic crisis expected to impact all entities in an industry or particular economic region; or
- misstatements identified to date that the entity plans to correct in a later draft of the financial statements.

When may it be inappropriate to annualize relevant metrics from the income statement when establishing materiality? [ISA | 929.1900]

Annualizing the relevant metrics may be inappropriate for entities that experience seasonality or have business activities that do not occur evenly throughout the period.

What does it mean to annualize relevant metrics?

Annualizing relevant metrics is proportionally adjusting interim amounts to estimate the full-year amounts without any other adjustment.

Examples

How might we consider the impact of a change in circumstance of the entity on the estimated amounts? [ISA | 929.11689]

Fact pattern:

The engagement team for a clothing manufacturer with a calendar year end identifies PBTCO and total revenue as two relevant metrics.

As part of planning, the engagement team obtains interim financial statements for the quarter ended March 31, along with budgets and forecasts for the remainder of the year.

They also consider that:

- the business is not seasonal;
- margins of 30% are constant based on history;
- customer turnover has historically been minimal; and
- no expected macro-economic events occurred that would impact the entity.

At the beginning of April, a customer who represented approximately 20% of the entity's annual revenue ceased doing business with the entity.

Analysis:

Using the interim financial statements for the quarter ended March 31, along with budgets and forecasts, the engagement team first estimates the amounts of the relevant metrics by annualizing the first quarter results - i.e. they multiply the results by four.

Then, the engagement team reduces the annualized revenue by subtracting the former customer's revenue for:

- the quarter ended March 31 and
- the prior year period from April 1 through December 31

The engagement teams also reduces PBTCO to account for the loss of the customer based upon historical gross profit margins (i.e. subtracting the former customer's revenue for the periods above multiplied by 30%).

How might we consider the impact of seasonality on the estimated amounts of relevant metrics? [ISA | 929.2000]

Fact pattern:

Entity X is a retail entity with a January 31 period end. It earns a significant amount of its revenue during the holiday season in November and December.

As part of planning during the first quarter, the engagement team obtains the interim financial statements to estimate the amounts of the relevant metrics. The team identified revenue and PBTCO as relevant metrics in the prior year audit and determine that they are still relevant metrics in the current year audit.

Analysis:

If the engagement team annualizes the financial information at the interim date, they do not appropriately consider the expected increase in revenue and PBTCO during the holiday period.
To estimate the full-year amounts, the engagement teams annualizes revenue and PBTCO for the period outside of the holiday season and considers the prior period's results and the current period's budgeted results and published economic forecasts to estimate the amounts for the upcoming holiday season.

1.2.2 Adjust the relevant metrics, including the benchmark, when appropriate [ISA | 930]

What do we do?

Adjust the relevant metrics, including the benchmark, when they are not representative of normal continuing operations.

Why do we do this?

We establish materiality at a level that is appropriate in light of the particular circumstances. We adjust the amounts of the relevant metrics, including the benchmark, to determine amounts that represent the normal, continuing operations of the entity.

Execute the Audit

When do we adjust the amounts of the relevant metrics? [ISA | 930.11690]

We adjust the amounts in the following circumstances:

- significant items are included in the amounts that do not represent normal, continuing operations, or
- the relevant metric is volatile.

Do we adjust the relevant metrics if management makes adjustments to the metrics? [ISA | 930.1300]

We only make the same adjustments as management when we conclude that those adjustments are appropriate.

> For example, management might disclose an adjusted amount for profit before tax, to reverse recurring items such as amortization of intangible assets. However, we may consider that the amortization of intangible assets is part of the entity's normal continuing operations.
>
> If this was considered to be a non-GAAP metric, we would likely continue to use PBTCO as a relevant metric and consider whether the non-GAAP metric was also a relevant metric (see question 'Can we consider a non-GAAP metric/alternative performance measure as a relevant metric?').

How do we adjust the amounts of the relevant metrics? [ISA | 930.1400]

To adjust the amounts of the relevant metrics, we either:

- Adjust the amounts for significant items that do not represent normal, continuing operations, or
- Average the amounts when the relevant metric is volatile.

When we adjust the amounts, we include our rationale.

Are there circumstances when we may use both normalizing techniques? [ISA | 930.11710]

Yes. An engagement team may adjust the amounts for significant items and then average the resulting amount, when the resulting amount relates to a volatile metric.

How may we identify significant items that do not represent normal, continuing operations? [ISA | 930.1700]

We may identify these items by reviewing the current-period financial statements and the related notes - for example, an entity's interim period financial statements or press releases. We may also consider specific items that have come to our attention through our planning and risk assessment activities or in the course of our interim reviews — for example:

- inquiries with management,
- reviews of minutes to meetings of the board of directors,
- planning analytics,
- interim procedures over specific transactions, and
- interim analytical review procedures that identified other trends.

What are examples of significant items that do not represent normal, continuing operations? [ISA | 930.1800]

Examples of significant items that do not represent normal, continuing operations include:

Type of Significant Item	Examples
Non-recurring items	• a goodwill or long-lived asset impairment • a gain or loss on debt extinguishment • a gain or loss on disposal of a business
Recurring items with non-recurring significant increase or decrease	• a significant increase in legal costs, due to a one-time settlement paid to settle a

	litigation claim that is not typically for the business • an uncharacteristically high employee benefits expense, due to a one-time cost for a long term incentive plan

Are there instances when we may adjust for significant items that represent normal, continuing operations? [ISA | 930.11711]

We may adjust for a significant, recurring items that represent normal, continuing operations when the accounting for it results in an amount of the metric that does not represent the underlying operations of the entity. They may be identifiable in the financial statements or related notes.

Examples of when it may appropriate or inappropriate to adjust for a significant, recurring items that represent normal, continuing operations:

Example	Consideration
An entity that hedges foreign currency transactions, but does not apply hedge accounting.	We may adjust for the gains and losses each year that impact PBTCO and are expected to subsequently be reversed.
An entity where some type of restructuring is expected on a recurring basis.	It is not appropriate to adjust restructuring expense.

Can we adjust the relevant metrics for payments to owners? [ISA | 930.11712]

Yes, we conclude it is appropriate to adjust the relevant metrics for payments to owners:

- when the owner of an owner-managed entity takes much of the profit before tax as compensation. It may be appropriate to adjust for the owner's compensation.
- when owners of an entity do not take their return on investment out of the entity in the form of dividends, but instead do so through expenses that are charged to PBTCO (e.g. compensation, interest on 'quasi-equity'). It may be appropriate to adjust for those expenses.
- when some of an entity's debt is in the form of 'quasi-equity'. It may be appropriate to adjust for the related interest charges.

What are examples of significant, non-recurring items that it may be inappropriate to adjust the relevant metrics for? [ISA | 930.11713]

Examples of when it may be inappropriate to adjust the relevant metrics, because it may be part of the normal, continuing operations of the entity, include:

- an uncharacteristically high write-down of inventory during the period
- a write-off of a large trade receivables balance, due to a significant customer experiencing financial difficulties.

Can we adjust revenue for discontinued operations? [ISA | 930.6302]

No, we do not adjust revenue from continuing operations for revenue reported in discontinued operations.

How do we average the amounts of the relevant metrics? [ISA | 930.11714]

We average the current year and an appropriate number of prior years.

When we average the amounts of the relevant metrics, our rationale includes:

- our understanding of the entity, its industry and its environment that provides evidence that volatility that is inherent to the business exists, or
- evidence obtained to support that the volatility is expected to be temporary for an entity that has a single "volatile" year.

How do we determine the appropriate number of prior years when we use averaging to establish materiality? [ISA | 930.2000]

When **the volatility is cyclical,** we use averaging over the period of the cycle. When the volatility is random, we judgmentally determine a period that we believe is consistent with what users would likely use.

The longer the period we use, the more likely we are to include circumstances that are no longer relevant to our consideration of materiality. Generally, averaging over a shorter period of time, three to five years, is most appropriate.

Do we consider forecasts of future periods when we use averaging to establish materiality? [ISA | 930.2200]

No. We do not use forecasts relating to future periods when averaging amounts. We only use financial information relating to the current period under audit and an appropriate number of prior periods.

When is it not appropriate to average a 'volatile' relevant metric? [ISA | 930.2300]

We do not average amounts in cases where changes in the entity, its industry or its environment indicate that we can expect the new levels of the relevant metrics to be permanent (see question 'What do we mean when we talk about 'volatility' in a metric?').

1.3 Establish materiality as a specified amount [ISA | 933]

What do we do?

Establish materiality for the financial statements as a whole, expressed as a specified amount

Why do we do this?

Although materiality is a concept, it is not practical to design audit procedures and evaluate audit misstatements without establishing materiality as a specified amount. Materiality is not a calculation but rather a judgment we make based on quantitative and qualitative factors to arrive at a specified amount.

Execute the Audit

How do we establish materiality as a specified amount? [ISA | 933.1300]

To establish materiality as a specified amount, we:

- Consider the influence of qualitative factors
- Assess the appropriateness of materiality as a percentage of the relevant metrics, including the benchmark
- Assess whether materiality is appropriate compared to the prior audit

We express materiality as a whole amount rounded to three significant digits and document the factors considered in our determination.

US GAAP | How do we establish materiality if we are auditing predecessor/ successor period financial statements from the application of pushdown accounting in a business combination? [ISA | 933.11767]

We use the same process to establish materiality when we audit financial statements that includes predecessor/successor periods from the application of pushdown accounting in a business combination. We consider the users when determining the relevant factors and metrics.

We determine the purpose for the presentation in the predecessor/successor financial statements, and how the users use these financial statements to make judgments. This helps us understand what is important to the users.

For certain metrics - typically income statement metrics - the users may view the predecessor period as discontinued operations, because the nature of the business has changed significantly post-business combination. This would cause us to put less weight on the predecessor period. However, in other circumstances, the users may consider the predecessor and successor periods together.

Based on the above considerations, we establish materiality for each period presented. We may also identify certain accounts in either or both of the predecessor or successor financial statements, in which a smaller misstatement may influence the judgments of the users. In that case, we could establish a lower materiality for those particular accounts (see activity 'Determine whether to establish a lower materiality for particular accounts or disclosures ').

1.3.1 Consider the influence of qualitative factors when establishing materiality [ISA | 932]

What do we do?

Consider the influence of qualitative factors when establishing materiality

Why do we do this?

A reasonable user makes judgments based on the total mix of information available, both quantitative and qualitative. As such, we also consider the qualitative factors that may influence the judgments of the users to establish materiality at an appropriate amount.

Execute the Audit

What qualitative factors do we consider when establishing materiality? [ISA | 932.1300]

When determining whether a higher or lower amount of materiality is appropriate, we consider the factors below that are applicable to the entity. This is not an exhaustive list, so we may consider additional factors when establishing materiality.

Factor	Higher Amount	Lower Amount
Ownership structure	• Small number of well informed investors or owners/ Few external users of the entity's financial statements • Few changes in stakeholders have occurred or are expected	• Large number of investors or owners • Intention to list or register securities • Recent or expected sale of the entity
Debt Arrangements	• Entity with limited or no debt • Debt covenants with significant cushion • Debt holders have access to management and do not rely solely on audited financial statements	• Entity has significant debt • Debt covenants with little cushion or highly sensitive to operating results • Debt holders have limited access to management • Debt holders primarily rely on audited financial statements • Publically traded debt
Business environment	• Stable business environment • Viable sustainable business • Entity operates in a politically stable environment	• Volatile business environment • Eroding business results • Entity operates in a politically unstable environment • The entity operates in a highly regulated industry
Earnings/EPS Sensitivities	• Small changes in earnings or EPS have a limited impact on users	• Small changes in earnings or EPS have a significant impact on users

Do we consider all qualitative factors that would cause a misstatement to be material when establishing materiality? [ISA | 932.1500]

No. We consider those qualitative factors that are pervasive to the financial statements.

Materiality 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 us to evaluate them as material even if they are below materiality (see question 'How do we consider qualitative factors?' for further information regarding how we consider qualitative factors when evaluating uncorrected misstatements).

If there are qualitative factors related to one or more particular accounts or disclosures for which misstatements smaller than the materiality for the financial statements as whole could be considered material, we consider these factors when determining whether it is appropriate to establish a lower materiality level for those particular accounts or disclosures (see activity 'Determine whether to establish a lower materiality for particular accounts or disclosures').

1.3.2 Assess the appropriateness of materiality as a percentage of the relevant metrics, including the benchmark [ISA | 935]

What do we do?

Assess the appropriateness of materiality as a percentage of each relevant metric, including the benchmark

Why do we do this?

A reasonable user makes judgments based on the total mix of information available, both quantitative and qualitative. As such, we establish materiality as a percentage of the relevant metrics, including the benchmark, as our quantitative consideration of what may influence the judgments of the users.

Execute the Audit

How do we assess the appropriateness of materiality as a percentage of the relevant metrics, including the benchmark? [ISA | 935.1300]

We consider where materiality falls as a percentage of the relevant metrics, including the benchmark, considering qualitative factors (see question 'What qualitative factors do we consider?' for further information). Our consideration of qualitative factors indicate whether a higher or lower percentage of the relevant metrics is appropriate. For example, it may be appropriate to have a lower percentage of the relevant metrics for an entity with significant debt and highly sensitive debt covenants.

We also consider the relative degree to which the users focus on the benchmark as compared to the other relevant metrics. Often we will be more willing to consider a monetary value for materiality that is a higher percentage of a *less* significant metric than of a metric that is considered more significant to the judgments of the users.

> For example, suppose an entity had an accumulated deficit in the prior period but due to a growth in net income over the past few periods will have retained earnings.

In this case, our materiality might exceed the ordinarily identified percentage for net assets.

What guideline percentages of the relevant metrics, including the benchmark, do we consider when assessing the appropriateness of materiality? [ISA | 935.1700]

After we establish materiality as a specified amount, we assess the appropriateness of that amount using the guideline percentages in the table below. We assess materiality as a percentage of the benchmark and also assess materiality as a percentage of the other relevant metrics.

Relevant metric, including the benchmark	% of the relevant metrics, including the benchmark, for non-public interest entities	% of the relevant metrics, including the benchmark, for public interest entities
A net metric - e.g. PBTCO	3 - 10%	3 - 5%
Net assets/equity	0.5 - 3%	0.5 - 2%
EBITDA	3 - 5%	2 - 4%
A gross metric -e.g. total assets, total revenues or total expenses	0.5 - 3%	0.5 - 1%

The guideline percentages are not safe harbours, and we carefully evaluate the amount that may be material to financial statement users. In each case, materiality is evaluated relative to the needs of the financial statement users and its appropriateness is assessed based on a consideration of ***all*** relevant metrics, not solely the benchmark. Since materiality is based on an entity specific evaluation of facts and circumstances, it is not possible to prescribe a rule that fits every situation. The percentages are simply guidelines that act as an indicator and govern when consultation is necessary (see activity 'Consult with DPP in certain circumstances' to determine when consultation is necessary).

The guideline percentages for a net or gross metric may not be appropriate when a relevant metric, such as Funds From Operations (FFO) or another alternative performance measure, is derived from a net or gross metric but represents a different amount. In such cases, additional judgment is necessary when evaluating whether materiality is appropriate. For these metrics, the guideline percentages for EBITDA may be appropriate.

When a metric is derived from EBITDA (i.e. 'adjusted EBITDA') and excludes certain non-recurring expenses, we think about whether the guideline percentages for EBITDA are appropriate to use based upon the amounts of those adjustments.

What is a gross metric when establishing materiality? [ISA | 935.1400]

A gross metric is an individual financial caption, or a summary of financial captions of similar balances (i.e. debit or credit balances), that is not reduced by other financial statement captions. Examples of gross metrics include total revenue, total assets, and total expenses.

An exception to this is net revenue. Net revenue consists of some deductions to revenue - e.g., sales returns - that may or may not appear as separate financial captions, but it is still be considered a gross metric.

Net assets/equity is neither a gross nor a net metric for the purpose of establishing materiality.

What is a net metric when establishing materiality? [ISA | 935.2100]

A net metric will consist of financial statement captions that both are added and subtracted from one another to arrive at a net amount — e.g. PBTCO.

Net assets/equity is neither a gross nor a net metric for the purpose of establishing materiality.

What are public interest entities? [ISA | 935.1800]

Refer to the Global Quality & Risk Management Manual https://www.gqrmm-prod.kworld.kpmg.com/G/0/Content/303 for the definition of a public interest entity.

What is EBITDA? [ISA | 935.10000]

EBITDA is earnings (i.e. net income or profit) before interest, taxes, depreciation and amortization.

When management has made additional adjustments to EBITDA, that metric is referred to as 'adjusted EBITDA' and is not treated as 'EBITDA.'

If a regulator requires a certain percentage of the benchmark or other relevant metrics, do we use that to establish materiality? [ISA | 935.2600]

If a regulator requires a certain percentage of the benchmark or other relevant metrics to establish materiality, we use that percentage as our maximum amount for materiality. However, we also consider qualitative factors (see question 'What qualitative factors do we consider?' for further information) to determine whether it is appropriate to use a lower percentage.

What if materiality exceeds the percentages when establishing materiality? [ISA | 935.2400]

If materiality exceeds the percentages for our other relevant metrics, we document our considerations and the judgments we made as to why that is appropriate. We also document why those other relevant metrics may be less important to the users. We do not disregard the relevant metrics.

If we do exceed the percentages for the benchmark, and the benchmark is not the presumed benchmark in the MBT or there is no presumed benchmark (i.e. the MBT is not applicable to the circumstances of the entity), we consult with DPP (see activity 'Consult with DPP in certain circumstances').

If we are within the percentages does that mean we have established an appropriate materiality? [ISA | 935.6301]

No. The percentages are simply guidelines and act as an indicator to help us identify situations where we may have incorrectly established materiality.

Since we establish materiality on an entity-by-entity basis, an amount within the percentages for the benchmark and relevant metrics may be too large when we consider qualitative factors (see question 'What qualitative factors do we consider?' for further information) and the relevant metrics in total.

1.3.3 Assess whether materiality is appropriate compared to the prior audit [ISA | 937]

What do we do?

IF materiality or materiality as a percentage of the benchmark has significantly changed from the prior audit, THEN assess whether the current-period materiality is appropriate.

Why do we do this?

Users of the financial statements will not vary their consideration of what is material for an entity by significant amounts year on year, unless circumstances at the entity have changed. Comparing materiality to the prior audit provides a sense check on our materiality determination.

Execute the Audit

What is a significant change in materiality or materiality as a percentage of the benchmark from the prior audit? [ISA | 937.1300]

We consider a change of +/-20% as significant.

For example, if the materiality amount was 30 in the prior audit and is 28 in the current period audit, we do not consider this to be a significant change (28-30/30 = 6.7%). However, if the materiality amount is 24 in the current period audit, we consider this to be a significant change (24-30/30 = 20%).

Similarly, if materiality represented 4% of the benchmark last year and 4.7% of the benchmark in the current period this would not be significantly different (4.7%-4.0%/4% = 17.5% change). However, if it represents 4.9% of the benchmark in the current period this would be significantly different (4.9%-4%/4% = 22.5% change).

What if there is a significant change in materiality from the prior audit? [ISA | 937.1400]

We assess whether the determined materiality remains appropriate. This includes assessing the basis for the change and what circumstances changed (e.g. significant change in the metrics due to a significant acquisition or change in qualitative factors, such as the entity's ownership changing from being privately-held to being listed).

For example, in the current year, an entity paid down its significant outstanding debt for which debt covenants were highly sensitive to operating results and also acquired multiple key customers, resulting in a significant increase in revenues and earnings in the current year. As a result, materiality appropriately increased due to significant change in the metrics and a change in qualitative factors (i.e. debt arrangements).

Alternatively, there may be a change in circumstance for an entity but not a basis for change in materiality. For example, for liquidating investments/funds, although we change the benchmark from Total assets in the prior year to Total distributions in the current year, it is generally not appropriate for materiality in the current year to exceed materiality from the prior audit considering the entity is only disposing of the previously existing assets.

If we determine that materiality is not appropriate, then we re-perform the steps to establish an appropriate materiality (see activity 'Establish materiality for the financial statements as a whole ').

When there has been a significant change, we document the circumstances that changed and our basis as to why the change is appropriate.

1.4 Consult with DPP in certain circumstances [ISA | 938]

What do we do?

IF certain circumstances exist, THEN consult with the Department of Professional Practice and document our consultation.

Why do we do this?

Although we use judgment to establish materiality, specific guidelines exist to help us set a consistent materiality to enable us to gain sufficient appropriate audit evidence to support our audit opinion. When we go too far outside these guidelines, we consult with DPP to help us determine whether the significant judgments made by us are appropriate.

Execute the Audit

In what circumstances do we consult with DPP on materiality? [ISA | 938.1401]

We consult with DPP when the benchmark is not:

- one of the presumed metrics identified in the MBT applicable to the circumstances of the entity (see question 'What is the Metrics and Benchmark Table?' for further information);
- net assets/equity; or
- EBITDA.

We also consult with DPP when:

- materiality falls outside the specific percentages for the benchmark and the presumed benchmark is not used or there is no presumed benchmark (i.e. the MBT is not applicable to the circumstances of the entity); or
- materiality for liquidating investment funds/trusts exceeds 3% of total distributions for non-public interest entities or 1% for public interest entities.

What are the specific percentages of the benchmark when determining whether to consult with DPP? [ISA | 938.1501]

When the benchmark is not the presumed benchmark in the MBT, we consult with DPP when we determine that it is appropriate for materiality to fall outside the percentages in the table:

Benchmark	% of the benchmark for non-public interest entities	% of the benchmark for public interest entities

A net benchmark - e.g. PBTCO	3 - 10%	3 - 5%
Net assets/equity	0.5 - 3%	0.5 - 2%
EBITDA	3 - 5%	2 - 4%
A gross benchmark -e.g. total assets, total revenues or total expenses	0.5 - 3%	0.5 - 1%

What are public interest entities? [ISA | 938.1700]

Refer to the Global Quality & Risk Management Manual https://www.gqrmm-prod.kworld.kpmg.com/G/0/Content/303 for the definition of a public interest entity.

What is EBITDA? [ISA | 938.10000]

EBITDA is earnings (i.e. net income or profit) before interest, taxes, depreciation and amortization.

When management has made additional adjustments to EBITDA, that metric is referred to as 'adjusted EBITDA' and is not treated as 'EBITDA.'

2 Determine whether to establish a lower materiality for particular accounts or disclosures [ISA | 939]

What do we do?

Determine whether there are particular accounts or disclosures for which we establish a lower materiality AND the amount of the lower materiality, when applicable.

Why do we do this?

We establish a materiality level for the financial statements as a whole. But we also identify accounts or disclosures where misstatements smaller than the materiality for the financial statements as whole would be considered material.

This will enable us to plan and perform appropriate procedures and to identify a material misstatement over those particular accounts or disclosures that users are particularly sensitive to.

Execute the Audit

Which particular accounts or disclosures do we establish a lower materiality for? [ISA | 939.1300]

We establish a lower materiality for particular accounts or disclosures for which there is a 'substantial likelihood,' or 'a reasonable expectation' that a misstatement smaller than the materiality for the financial statements as whole would be considered material to the users of the financial statements (see question 'Where may we obtain information to determine what is important to users?' for sources of information that may help us identify those particular accounts or disclosures).

It is not common to identify particular accounts or disclosures for which we establish a lower materiality.

How do we apply the terms 'substantial likelihood' and 'reasonable expectation'? [ISA | 939.1600]

We consider whether the users of the financial statements would place a level of importance on a misstatement within a particular account or disclosure that:

- is lower than our materiality for the financial statements as a whole; and
- would merit a lower materiality being applied to that account or disclosure.

We use our judgment to determine what accounts or disclosures meet this threshold.

What factors may think about when determining whether to establish a lower materiality for particular accounts or disclosures? [ISA | 939.2000]

Similar to materiality for the financial statements as a whole, each entity will be specific to the entity in terms of its relevant factors. However, we think about the following factors.

Factor	Example
Whether law, regulation or the applicable financial reporting framework affect users' expectations regarding the measurement or disclosure of certain items	• Related party transactions - There is usually more sensitivity surrounding related party transactions and whether there is a conflict of interest. • Compensation of management and those charged with governance (TCWG) - There may be more sensitivity surrounding the disclosure of compensation of management and TCWG. • Sensitivity analysis for fair value accounting estimates with high estimation uncertainty (a misstatement in the sensitivity analysis may influence users' judgments, in addition to the fair value accounting estimate itself).
The key disclosures in relation to the industry in which the entity operates	Research and development costs for a pharmaceutical company - Users may use this as a leading indicator of future results to help identify if new products are on the horizon.
Whether attention is focused on a particular aspect of the entity's business that is separately	Disclosures about segments or a significant business combination.

disclosed in the financial statements	

How do we determine the lower materiality amount for particular accounts or disclosures? [ISA | 939.1800]

Similar to the process we used to establish materiality for the financial statements as a whole, we consider quantitative and qualitative factors that are specific to those particular accounts or disclosures. We document the amount of the lower materiality for particular accounts and disclosures and the factors considered when determining the amount.

Do we consider aggregation risk when determining a lower materiality amount? [ISA | 939.2300]

No. We consider aggregation risk when we determine our performance materiality (sometimes referred to as 'tolerable misstatement').

Group Audit | How do we determine whether to establish a lower group materiality for particular accounts or disclosures? [ISA | 939.159839]

As the group auditor, we determine whether to establish a lower group materiality for particular accounts or disclosures in the same way as in a stand-alone audit, but consider the amounts from the consolidated financial statements.

Examples

How do we determine a lower materiality for a particular account or disclosure? [ISA | 939.11529]

Scenario 1 | Lower materiality for a particular account or disclosure is appropriate

Fact pattern:

The engagement team is auditing a bond fund, and establishing materiality as part of their planning. The fund offers professional selection and management of a portfolio of fixed-income securities. Investors buy shares in the bond fund based on the net asset value (NAV). The NAV is calculated by dividing the fund's total assets by the number of shares outstanding. In addition, the fund makes money from the interest earned on the securities it owns or by selling those securities at a profit. The fund distributes dividends based on these earnings.

The engagement team established materiality after considering net assets, PBTCO and total assets.

Analysis:

The engagement team noted that the amount of dividends distributed to the investors was based on the interest earned. While the value of the funds was determined by the NAV, investors considered the dividends received when making judgments. The team noted in industry reports that analysts discussed the amount of dividends various funds produced. As a result, the engagement team determined that a smaller misstatement in the interest earned account would be material to the users. Therefore, they determined a lower materiality for the interest earned account.

Scenario 2 | Lower materiality for a particular account or disclosure is appropriate

Fact pattern:

The engagement team is auditing a consumer product entity, and establishing materiality as part of their planning.

The entity produces different products by segment, and discloses the revenue per segment in the footnotes. In the current period, the entity has introduced a new product that it believes will become the market leader and will become the most significant product it sells in the future. The entity does not come out with products every year or two; this is a seminal change for the entity.

The engagement team reviews press releases, analyst reports and internal documentation, and notes that the product is often discussed when evaluating the entity's performance.

The engagement team establishes materiality after considering revenue, PBTCO and total assets.

Analysis:

The users were focused on the revenue growth in this product when they valued the entity. Although the revenue for the product was not a significant portion of the total revenue in the current period, the trend was significant to the users.

As a result, the engagement team determines that a smaller misstatement in that product segment revenue would be material the users. Therefore, the engagement team establishes a lower materiality for that segment revenue account.

Determining Performance Materiality When Planning the Audit

International Standards on Auditing: ISA 320.11

11. The auditor shall determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures. (Ref: Para. A13)

ISA Application and Other Explanatory Material: ISA 320.A13

Performance Materiality (Ref: Para. 11)

A13. Planning the audit solely to detect individually 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 at less than materiality for the financial statements as a whole to reduce aggregation risk to an appropriately low level. 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 in relation to misstatements in the current period.

How do we comply with the Standards? [ISA | KAEGHDWC]

1 Determine performance materiality [ISA | 940]

What do we do?

Determine performance materiality

Why do we do this?

We determine performance materiality during the audit to allow us to:

- assess risks of material misstatement (RMMs); and
- plan and perform our audit procedures.

We set performance materiality at an amount that appropriately reduces the probability that total uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole ("aggregation risk").

Execute the Audit

What is performance materiality? [ISA | 940.1400]

Performance materiality is a measure we use to assess and respond to risk at the assertion level. If we planned and performed our audit using materiality for the financial statements as whole, aggregation risk may be too high. Performance materiality, therefore, is an amount less than materiality for the financial statements as a whole.

How do we determine performance materiality? [ISA | 940.1500]

To determine performance materiality, we:

(1) Consider factors that affect aggregation risk;
(2) Assess the level of aggregation risk; and
(3) Determine an amount for performance materiality.

Do we determine performance materiality at the individual account level or for the financial statements as a whole? [ISA | 940.1600]

We determine performance materiality for the financial statements as a whole - as opposed to determining a performance materiality for each individual account or disclosure.

When do we determine a lower performance materiality for particular accounts or disclosures? [ISA | 940.11507]

When we establish a lower materiality level for particular accounts or disclosures, we also determine a lower performance materiality for those accounts or disclosures.

How do we determine performance materiality for accounts or disclosures for which a lower materiality was established? [ISA | 940.11508]

When we determine a lower materiality amount for a particular account or disclosure, we determine performance materiality by:

(1) Considering factors that affect aggregation risk for the particular account or disclosure (See question 'What factors do we consider in determining performance materiality for a particular account or disclosure?');

(2) Assess the level of aggregation risk for the particular account or disclosure (See question 'How do we assess the level of aggregation risk for a particular account or disclosure?'); and

(3) Determine an amount for performance materiality for the particular account or disclosure (See question 'How do we determine performance materiality as an amount for particular accounts or disclosures?').

Group Audit | What do we use group performance materiality for in a group audit? [ISA | 940.2100]

As the group engagement team, we use group performance materiality to plan and perform our work, including our procedures over the consolidation process and any RMMs of the group financial statements we identify and respond to in the group audit file (see question "Do we document every RMM of the group financial statement in the group engagement file?" for further information).

1.1 Consider the factors that affect aggregation risk [ISA | 941]

What do we do?

Consider the factors that affect aggregation risk, including the nature, cause and amount of misstatements

Why do we do this?

The determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. Considering factors that are specific to the entity allows us to determine the appropriate level of aggregation risk.

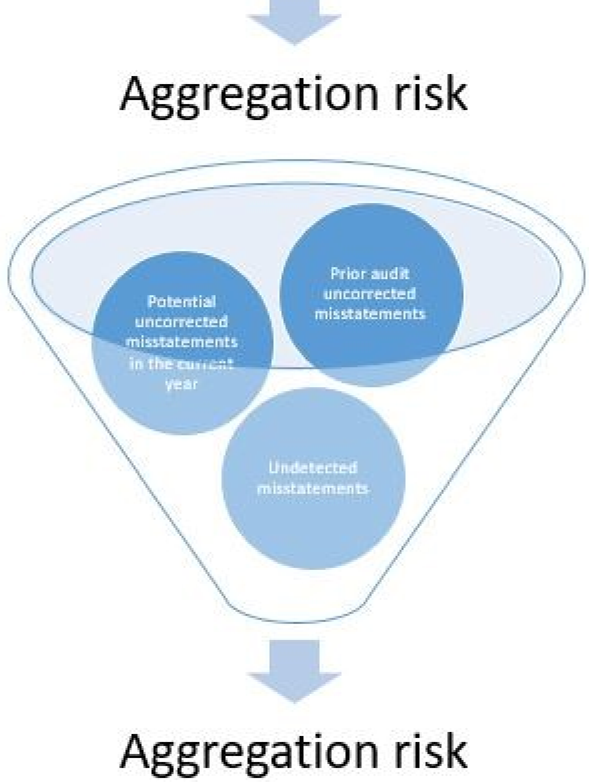
Execute the Audit

What is aggregation risk? [ISA | 941.1300]

Aggregation risk is the risk that uncorrected and undetected misstatements exist and exceed materiality for the financial statements as a whole.

We don't usually apply audit procedures to every individual transaction in the financial statements, so most of our audits have some level of aggregation risk. This level of risk varies from audit to audit, but will be linked to factors that ultimately impact the likelihood — i.e. risk — that uncorrected and undetected misstatements exist in the financial statements.

Our assessment of aggregation risk will include both historical knowledge of the entity and information we have obtained during the current period audit.



What is an uncorrected misstatement? [ISA | 941.1500]

An uncorrected misstatement is a misstatement that is not clearly trivial - i.e. that we accumulated - and that management has not corrected.

How do uncorrected misstatements impact aggregation risk? [ISA | 941.1600]

Uncorrected misstatements increase our assessment of aggregation risk. This is because they reduce the level of additional errors (both known and unknown) that we'd be willing to tolerate in our audit before a material misstatement exists. In addition, misstatements identified in the prior period are an indicator that similar misstatements may also occur in the current period.

We can think about materiality as an empty bucket, and uncorrected misstatements as water poured into the bucket. When there are known uncorrected misstatements, we are starting with a bucket that already has water in it. As a result, the bucket has reduced capacity to hold more water (new misstatements) before overflowing (material misstatement).

What are undetected misstatements? [ISA | 941.1900]

Undetected misstatements are misstatements that exist in the financial statements, but we do not detect.

Since we do not apply audit procedures to 100% of the financial statements, it is likely there are undetected misstatements. The fact that we use sampling techniques or we may not perform procedures in all of the components of a group increases the risk of undetected misstatements.

What do we think about when we evaluate the potential for undetected misstatements? [ISA | 941.2000]

When we evaluate the potential for undetected misstatements, we think about:

- the entity's overall history of misstatements;
- the strength of its internal control over financial reporting; and
- other entity-specific factors that suggest an environment with an increased potential for misstatements to occur, specifically turnover of senior staff.

Group Audit | How does aggregation risk arise in a group audit and how is it addressed? [ISA | 941.1310]

In a group audit, aggregation risk arises and is addressed in the following ways:

Aggregation risk arises when	Aggregation risk is addressed by setting...
We plan and perform audit procedures to address risks of material misstatement audited at the group level	Group performance materiality
We plan and perform audit procedures to address risks of material misstatement at components level in the group	Component performance materiality (Component materiality as a step in determining component performance materiality)

What factors do we consider that affect aggregation risk when determining performance materiality? [ISA | 941.1400]

When we assess the level of aggregation risk, we consider factors that are specific to the entity. These are set out in the table below.

Factor	Consideration
Deficiencies in CERAMIC	The greater the number and severity of CERAMIC control deficiencies, the greater the aggregation risk
Number and severity of deficiencies in control activities, including pervasiveness of internal control deficiencies	The more severe and pervasive the internal control deficiencies, the greater the aggregation risk
History of misstatements (the nature, cause (if known) and amount) that were accumulated in audits of the financial statements of prior periods (both corrected and uncorrected)	The greater the magnitude of the misstatements, the greater the aggregation risk
Level of turnover of senior management or key financial reporting personnel	The greater the turnover, the greater the aggregation risk
Management's preparedness/willingness to correct misstatements	The less willing management are to correct misstatements, the greater the aggregation risk

Proportion of accounts not identified as significant accounts	The larger the proportion of accounts not identified as significant accounts, the greater the aggregation risk

Group Audit | What factors affect aggregation risk when determining group performance materiality? [ISA | 941.1800]

As the group auditor, when we assess the level of group aggregation risk for determining group performance materiality in a group audit, we consider the same factors as when setting performance materiality for a stand-alone audit. Some more specific considerations we make in a group audit with respect to each of the factors are set out in the table below.

Factor	Group audit specific consideration
Deficiencies in CERAMIC	The greater the number and severity of CERAMIC control deficiencies at the group level, the greater the aggregation risk
Number and severity of deficiencies in control activities, including pervasiveness of internal control deficiencies	The greater the number and more pervasive the internal control deficiencies across the group, the greater the aggregation risk
History of misstatements (the nature, cause (if known) and amount) that were accumulated in audits of the financial statements of prior periods (both corrected and uncorrected)	The greater the quantity and magnitude of the misstatements identified across the group, the greater the aggregation risk
Level of turnover of senior management or key financial reporting personnel	The greater the turnover of group senior management or group key financial reporting personnel, the greater the aggregation risk
Proportion of accounts where there are no substantive procedures performed by either component teams or the group auditor	The larger the proportion of accounts in the group financial statements where no substantive procedures are performed, the greater the aggregation risk

What factors do we consider in determining performance materiality for a particular account or disclosure? [ISA | 941.2100]

When we have established a lower materiality level for a particular account or disclosure, we consider the following factors to assess aggregation risk in the account balance:

- the number and severity of deficiencies in control activities related to the particular account or disclosure; and

- the history of misstatements (the nature, cause (if known) and amount) related to the particular account or disclosure that were accumulated in prior-period audits of the financial statements (both corrected and uncorrected).

1.2 Assess the level of aggregation risk [ISA | 942]

What do we do?

Assess the level of aggregation risk as Normal, Increased or High

Assess the level of aggregation risk as Low, Normal, Increased or High

Why do we do this?

Based on our evaluation of the factors that increase aggregation risk, we assess aggregation risk as one of three levels, either Normal, Increased or High. This level helps us to determine an appropriate amount for performance materiality.

Based on our evaluation of the factors that increase aggregation risk, we assess aggregation risk as one of four levels, either Low, Normal, Increased or High. This level helps us to determine an appropriate amount for performance materiality.

Execute the Audit

Enhanced | How do we assess the level of aggregation risk when determining performance materiality? [ISA | 942.1300]

We assess aggregation risk by considering various entity-specific factors based on our prior experience with the engagement or our knowledge of the predecessor's experience with the engagement, if an initial audit. Although aggregation risk exists on a continuum, we use a tiered approach to assess the level of aggregation risk, ranked as Normal, Increased or High.

Core and Less Complex | How do we assess the level of aggregation risk when determining performance materiality? [ISA | 942.1300]

We assess aggregation risk by considering various entity-specific factors based on our prior experience with the engagement or our knowledge of the predecessor's experience with the engagement, if an initial audit. Although aggregation risk exists on a continuum, we use a tiered approach to assess the level of aggregation risk.

We first consider the factors that affect aggregation risk and determine whether those factors indicate an aggregation risk level of Normal, Increased or High. If our assessment indicates the level of aggregation risk as Normal, we determine whether we may assess the level of aggregation risk as Low.

How do we assess the level of aggregation risk as Normal, Increased or High? [ISA | 942.1400]

We consider the factors that affect aggregation risk (see question 'What factors do we consider that affect aggregation risk?') and determine whether those factors indicate Normal, Increased or High aggregation risk.

The table below sets out examples of how the factors affect our assessment of aggregation risk.

Factor	Indicators of Normal aggregation risk	Indicators of Increased aggregation risk	Indicators of High aggregation risk
Deficiencies in CERAMIC	An entity that has historically had no or very few CERAMIC control deficiencies.	An entity that has historically had several CERAMIC control deficiencies, but none that were significant deficiencies/ material weaknesses, individually or in the aggregate.	An entity that has historically had several CERAMIC control deficiencies, including some that were significant deficiencies/material weaknesses.
Number and severity of deficiencies in control activities, including pervasiveness of internal control deficiencies	An entity that has historically had no or few non-pervasive deficiencies in its control activities.	An entity that has historically had several non-pervasive deficiencies in its control activities and/or deficiencies in its control activities that are pervasive and impact several different accounts.	An entity that has historically had significant deficiencies/material weaknesses in its control activities and/or deficiencies in its control activities that are considered to have a pervasive impact.
History of misstatements (the nature, cause (if known), and amount) that were accumulated in audits of the financial statements of prior periods (both corrected or uncorrected)	An entity that has historically had no misstatements or had misstatements (corrected or uncorrected) that were significantly less than materiality, individually or in the aggregate, and impacted only a few accounts.	An entity that has historically had misstatements (corrected or uncorrected) that did not approach or exceed materiality, individually or in the aggregate, but impacted several different accounts.	An entity that has historically had misstatements (corrected or uncorrected) that approached or exceeded materiality, individually or in the aggregate, and impacted several different accounts.

Level of turnover of senior management or key financial reporting personnel	An entity that has recently had no or very little turnover in senior management, none of which related to potential impropriety or fraud.	An entity that has recently had some turnover in senior management (being a few key positions), none of which related to potential impropriety or potential fraud.	An entity that has recently had significant amount of turnover in senior management (being several key positions), or has turnover that related to potential impropriety or fraud.
Management's preparedness/ willingness to correct misstatements	Management corrects all misstatements identified that are considered more than clearly trivial amounts — i.e. above our audit misstatement posting threshold.	Management often does not correct misstatements that are more than clearly trivial amounts (above our audit misstatement posting threshold). However, in the past the amounts did not approach materiality, both individually and in the aggregate.	Management rarely corrects misstatements identified and only does so if they approach or exceed materiality, individually or in the aggregate.
Proportion of accounts not identified as significant accounts	A smaller value of the total accounts identified are determined to be non-significant accounts.	A moderate value of the total accounts identified are determined to be non-significant accounts.	A larger value of the total accounts identified are determined to be non-significant accounts.

Are any factors more important than others when assessing the level of aggregation risk to determine performance materiality? [ISA | 942.1500]

No. No one factor is more important than another, but rather their importance varies with the entity's specific circumstances.

When we establish performance materiality, we consider all the factors that impact aggregation risk for the entity for that particular audit period. We use our prior experience with the engagement to assist but also consider current period changes.

In some periods, we may determine one factor to be more relevant than the next. As such, the respective weight we put on each factor will be engagement-specific.

Core and Less Complex | How do we assess the level of aggregation risk as Low? [ISA | 942.157295]

To assess aggregation risk as Low:

(1) The factors in the question 'What factors do we consider that affect aggregation risk when determining performance materiality?' indicate Normal aggregation risk;
(2) The engagement does not meet any of the characteristics that preclude us from assessing the level of aggregation risk as Low (see question 'What precludes us from assessing the level of aggregation risk as Low?'); and
(3) The additional factors in the question 'What are the additional factors that we consider to assess Low aggregation risk?' indicate the level of aggregation risk as Low.

Core and Less Complex | What precludes us from assessing the level of aggregation risk as Low? [ISA | 942.157296]

If the engagement has any of the characteristics in the table below, we do not assess aggregation risk as Low:

Characteristic	Guidance
Initial audit engagement	Prior audit experience with the entity provides us with more reliable information about the level of aggregation risk than can be obtained in an initial audit. Accordingly, we do not assess aggregation risk as Low in our first year of auditing an entity.
Audit of a high public profile entity	We do not assess aggregation risk as Low for audits of high public profile entities. (See 'What is the definition of a high public profile entity?')

Core and Less Complex | What are the additional factors that we consider to assess Low aggregation risk? [ISA | 942.8969]

The table below sets out the additional factors that we consider to determine whether we may assess aggregation risk as Low or continue to assess aggregation risk as Normal.

Additional factors affecting aggregation risk	Consideration	Indicators of Low aggregation risk	Indicators of Normal aggregation risk
Number of significant risks indicated	The greater the number of significant risks, the less likely we are to conclude there is Low	An entity with no or few significant risks other than the risk of management override of controls	An entity with multiple significant risks in addition to the risk of management override of controls

	aggregation risk.		
Nature of assets, liabilities and transactions	The more complicated the accounting requirements are for the entity's transactions, the less likely we are to conclude there is Low aggregation risk.	The entity processes routine transactions and the accounts do not require complex accounting or significant judgments. For example, an entity that enters into routine transactions that follow a simple revenue recognition model.	The entity processes non-routine or unusual transactions and the accounts require complex accounting or significant judgments. For example: • complex multiple-element revenue arrangements; or • complex derivatives.
Nature of the accounting processes, including IT systems	The more complex the entity's accounting processes and IT systems, the less likely we are to conclude there is Low aggregation risk.	The entity has simple record-keeping with few accounting processes. The entity has few IT systems and uses pre-packaged purchased applications with no access to the source code.	The entity has complex record-keeping with many accounting processes. The entity has many IT systems (or many instances of a single system) and customizes the systems for the entity's specific needs.
Number of components/ locations at which separate accounting processes and IT systems exist	The more components/ locations at which separate accounting processes and IT systems exist, the less likely we are to conclude there is Low aggregation risk.	• The group entity has few components at which separate accounting processes and IT systems exist. • The entity has only a few locations at which separate accounting processes and IT systems exist.	• The group entity has many components at which separate accounting processes and IT systems exist. • The entity has many locations at which separate accounting processes or IT systems exist.

Core and Less Complex | Is it necessary for all the additional factors affecting aggregation risk to indicate Low aggregation risk to assess aggregation risk as Low? [ISA | 942.8970]

No. When we consider all of the additional factors, we also consider their relative importance to the entity. The respective weight we put on each factor will be engagement-specific, and we may determine certain factors to be more relevant than others. For example, a single factor may indicate that Normal aggregation risk is appropriate. As the number and importance of additional factors indicating Normal aggregation risk increases, we are less likely to assess aggregation risk as Low.

Initial Audit | If we are performing an initial audit and don't have prior experience with the entity, do we assess aggregation risk as Increased or High? [ISA | 942.1600]

Not necessarily. We assess our level of aggregation risk for each entity independently; prior experience just helps us.

When we perform an initial audit engagement, it may be harder to assess whether any of the above risk factors is present, so it may be appropriate to assess the level of aggregation risk as Increased or High.

How do we assess the level of aggregation risk for a particular account or disclosure? [ISA | 942.1700]

When we determine a lower materiality for a particular account or disclosure, we assess the related aggregation risk by starting with the same aggregation risk we determined for the financial statements as a whole.

We then consider whether the factors for the particular account or disclosure may cause us to increase the aggregation risk (see question 'What factors do we consider in determining performance materiality for a particular account or disclosure?').

The table below sets out examples of how the factors affect our assessment of aggregation risk for the particular account or disclosure.

Factor	Consideration
Number and severity of deficiencies in control activities related to the particular account or disclosure	The higher the number and the more severe the deficiencies in control activities related to the particular account or disclosure, the greater the aggregation risk.
History of misstatements (the nature, cause (if known) and amount) related to the particular account or disclosure that were accumulated in prior-period audits of the financial statements (both corrected or uncorrected)	The greater the magnitude of the misstatements related to the particular account or disclosure, the greater the aggregation risk.

Examples

Core and Less Complex | How do we assess the level of aggregation risk? [ISA | 942.1401]

Scenario 1

Fact pattern

Entity U is a non-public healthcare entity that operates numerous patient care facilities domestically and does not meet the criteria to use the International-Enhanced methodology or KPMG Clara workflow - Enhanced. The engagement team has determined aggregation risk as Normal and therefore further considers whether a Low level of aggregation risk is present.

The engagement does not have any of the characteristics that preclude the engagement team from assessing the level of aggregation risk as Low:

Characteristics	Consideration of the characteristic
Initial audit engagement	Entity U is not an initial audit.
A high public profile entity	Entity U is not a high public profile entity.

The engagement team considers the additional factors to assess whether aggregation risk may be Low.

Additional factors affecting aggregation risk	Consideration of the factor
Number of significant risks indicated	The engagement team has identified one significant risk in addition to the risk of management override of controls and a risk of fraud related to revenue recognition.
Nature of assets, liabilities and transactions	Entity U's transactions are routine. They follow a simple revenue recognition model and do not have any other complex accounting transactions, such as complex derivatives.
Nature of the accounting processes and controls, including IT systems	Entity U uses a single ERP system but has multiple separate transaction processing systems that are not integrated with the ERP system which require batch processing and/or manual uploads of data rather than automated interfaces.

Number of components/ locations at which separate accounting processes and IT systems exist	All of the patient care facilities have accounting processes that follow the same policies, practices and procedures and use the same IT system.

Analysis

The engagement did not have any characteristics that would preclude determination of Low aggregation risk. Additionally, the engagement team's analysis identified several additional factors that indicated a Low level of aggregation risk, but also identified one indicator of a Normal level of aggregation risk related to nature of accounting processes and controls, including IT systems.

Based upon consideration of all additional factors together, the engagement team determines that the level of aggregation risk is Low.

Scenario 2

Fact pattern

Entity V is a non-public investment fund entity. The fund invests in a variety of different types of investments, some of which are classified as Level 3. The engagement team has determined aggregation risk as Normal and therefore decides to further consider whether a Low level of aggregation risk is present.

The engagement does not have any of the characteristics that preclude the engagement team from assessing the level of aggregation risk as Low:

Characteristics	Consideration of the characteristic
Initial audit engagement	Entity V is not an initial audit.
A high public profile entity	Entity V is not a high public profile entity.

The engagement team considers additional factors to assess whether aggregation risk may be Low.

Additional factors affecting aggregation risk	Consideration of the factor
Number of significant risks identified	The engagement team has identified four significant risks in addition to the risk of management override of controls.
Nature of assets, liabilities and transactions	Entity V's transactions are routine purchases and sales of investments.
Nature of the accounting processes and controls, including IT systems	Entity V uses a single platform for fund administration that has automated

	interfaces with the custodian's platform and a third-party trading platform. On a daily basis, the underlying transactions are uploaded into the fund administration system without any manual intervention.
Number of components/ locations at which separate accounting processes and IT systems exist	The entity has no components or locations.

Analysis

The engagement did not have any characteristics that would preclude determination of Low aggregation risk. Additionally, while the engagement team's consideration of the additional factors identified several factors that indicated a Low level of aggregation risk, they also identified two indicators of a Normal level of aggregation risk related to the level of aggregation risk related to the nature of accounting processes and controls, including IT systems, and the number of significant risks identified.

Based upon consideration of all additional factors together, the engagement team determines that the level of aggregation risk is Normal.

1.3 Determine an amount for performance materiality [ISA | 943]

What do we do?

Determine performance materiality as an amount and, if applicable, a lower performance materiality amount for particular accounts and disclosures

Why do we do this?

Once we have evaluated the factors and determined our level of aggregation risk, we determine a performance materiality (PM) amount. This enables us to:

- assess risks of material misstatement (RMMs); and
- plan and perform our audit procedures.

Execute the Audit

Enhanced | How do we determine performance materiality as an amount? [ISA | 943.6245]

We determine performance materiality at the amount that reduces aggregation risk to an appropriately low level.

In doing so, we use the level of aggregation risk we assessed and determine the amount of performance materiality as follows:

When aggregation risk is assessed as:	Performance materiality is determined as:
Normal	75% of materiality
Increased	65% of materiality
High	50% of materiality

We document our determined performance materiality amount and the factors considered in our determination.

We express performance materiality as an amount that is rounded to three significant digits.

Core and Less Complex | How do we determine performance materiality as an amount? [ISA | 943.8972]

We determine performance materiality at the amount that reduces aggregation risk to an appropriately low level.

In doing so, we use the level of aggregation risk we assessed and determine the amount of performance materiality as follows:

When aggregation risk is assessed as:	Performance materiality is determined as:
Low	85% of materiality
Normal	75% of materiality
Increased	65% of materiality
High	50% of materiality

We document our determined performance materiality amount and the factors considered in our determination.

We express performance materiality as an amount that is rounded to three significant digits.

If a regulator requires a certain percentage of materiality, do we use that to determine performance materiality? [ISA | 943.1800]

If a regulator requires a certain percentage of materiality to determine performance materiality, we use that percentage as our maximum amount for performance materiality.

For example, if a regulator requires performance materiality be 40% of materiality, we would establish performance materiality as an amount that did not exceed 40% of materiality.

Enhanced | How do we determine performance materiality as an amount for particular accounts or disclosures? [ISA | 943.6246]

We determine performance materiality at the amount that reduces aggregation risk to an appropriately low level.

In doing so, we use the level of aggregation risk we assessed for the particular account or disclosure and determine the amount of performance materiality for particular accounts or disclosures as follows:

When aggregation risk for the particular account or disclosure is assessed as:	Performance materiality for the particular account or disclosure is determined as:
Normal	75% of the lower materiality for the particular account or disclosure
Increased	65% of the lower materiality for the particular account or disclosure
High	50% of the lower materiality for the particular account or disclosure

We document our determined lower performance materiality amount(s) and the factors considered in our determination.

Core and Less Complex | How do we determine performance materiality as an amount for particular accounts or disclosures? [ISA | 943.9005]

We determine performance materiality at the amount that reduces aggregation risk to an appropriately low level.

In doing so, we use the level of aggregation risk we assessed for the particular account or disclosure and determine the amount of performance materiality for particular accounts or disclosures as follows:

When aggregation risk for the particular account or disclosure is assessed as:	Performance materiality for the particular account or disclosure is determined as:
Low	85% of the lower materiality for the particular account or disclosure
Normal	75% of the lower materiality for the particular account or disclosure
Increased	65% of the lower materiality for the particular account or disclosure
High	50% of the lower materiality for the particular account or disclosure

We document our determined lower performance materiality amount(s) and the factors considered in our determination.

Revision as the Audit Progresses

International Standards on Auditing: ISA 320.12-13

Revision as the Audit Progresses

12. The auditor shall 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: Para. A14)

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

ISA Application and Other Explanatory Material: ISA 320.A14

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

A14. 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 revises that materiality.

How do we comply with the Standards? [ISA | KAEGHDWC]

1 Determine whether to revise materiality and other materiality measures [ISA | 944]

What do we do?

Determine whether to revise materiality and other materiality measures, when appropriate

Why do we do this?

We ordinarily establish materiality and other materiality measures before the end of the period under audit.

After these are set, events may occur and conditions may change that might affect our assessment. These events and conditions include quantitative changes to the metrics and financial statement amounts and changes that impact our consideration of qualitative factors.

We re-evaluate our materiality (and other materiality measures) to determine whether our established materiality and other materiality measures are still reasonable based on the latest information and materiality is at an amount that users would consider as material.

Execute the Audit

How do we determine whether to revise materiality and other materiality measures? [ISA | 944.11785]

We determine whether to revise materiality by re-evaluating:

- materiality for the financial statements as a whole ; and
- materiality for a particular account or disclosure .

We determine whether to revise other materiality measures by re-evaluating:

- performance materiality ;
- performance materiality for a particular account or disclosure ;

When do we re-evaluate materiality and other materiality measures? [ISA | 944.1400]

We re-evaluate the established materiality level before evaluating misstatements and finalizing the audit to confirm that we have performed procedures at an appropriate level.

There may be natural points throughout the audit where we think about whether our materiality levels remain appropriate - for example, when we perform interim reviews.

What is the difference between re-evaluating and revising materiality (and other materiality measures)? [ISA | 944.1500]

Re-evaluating materiality and other materiality measures means looking back at the various factors and metrics we used initially and determining whether our original determinations are still appropriate. Revising materiality and other materiality measures means actually changing the amounts from what we originally determined.

In order to determine whether to revise, we first re-evaluate.

1.1 Re-evaluate materiality for the financial statements as a whole [ISA | 945]

What do we do?

Re-evaluate materiality for the financial statements as a whole and determine whether to revise materiality

Why do we do this?

We ordinarily establish materiality and other materiality measures before the end of the period under audit. After these are set, events may occur and/or conditions may change that might affect our assessment. These events and conditions include not only quantitative changes to the metrics and financial statement amounts but also changes affecting our consideration of other qualitative factors.

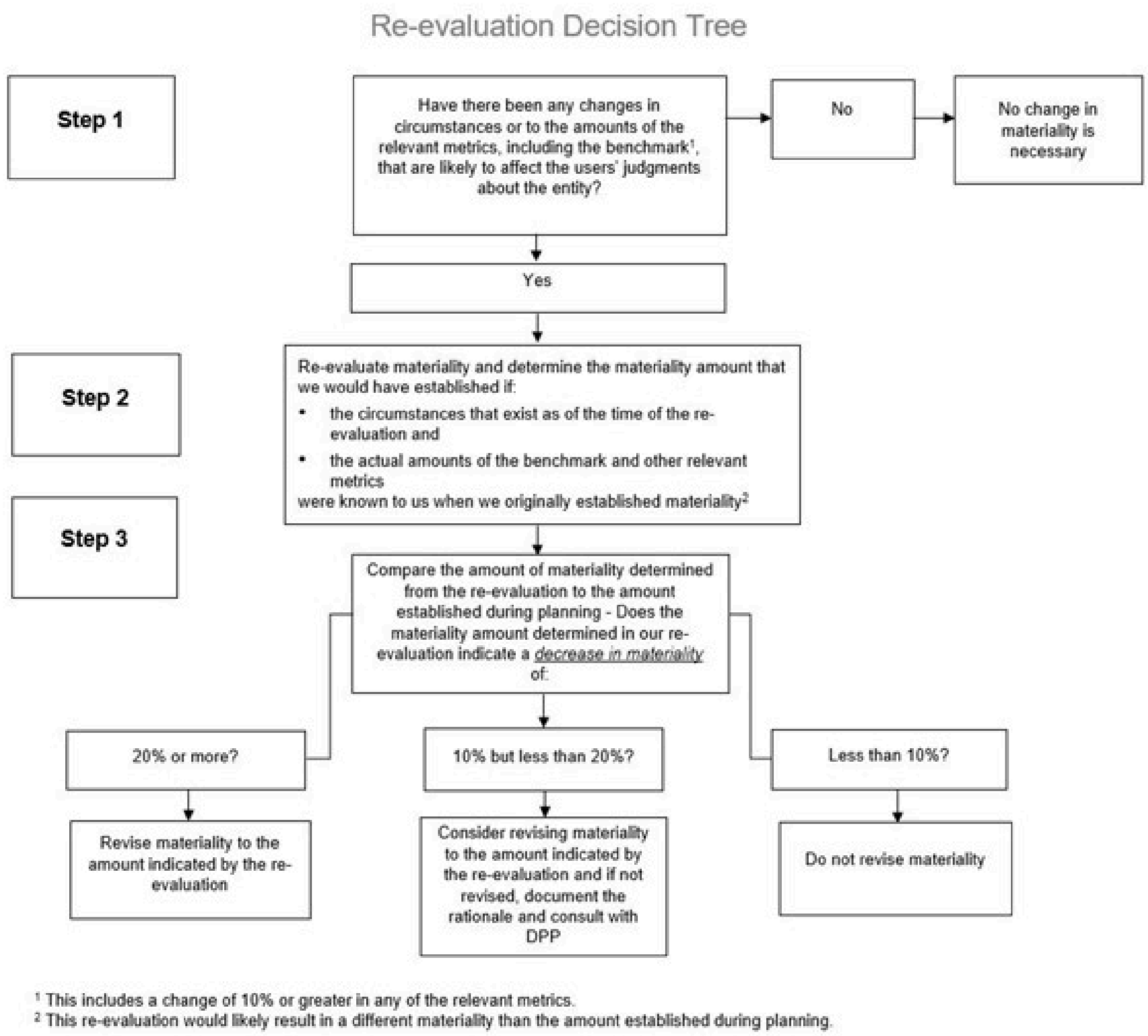
Re-evaluating materiality helps us confirm we have established materiality at a level that:

- is appropriate for the circumstances, and
- allows us to perform appropriate and sufficient audit procedures.

Execute the Audit

How do we re-evaluate materiality for the financial statements as a whole? [ISA | 945.1350]

The following flowchart illustrates the steps to re-evaluate materiality and determine if it is revised:



We re-evaluate materiality by:

- considering whether changes in circumstances have occurred; and
- determining the actual amounts of the relevant metrics, including the benchmark.

Changes in circumstances include situations when we become aware of information we did not know at the time we initially set materiality. We also determine whether there has been a 10% or greater decrease in the actual amounts of the benchmark or other relevant metrics. If the change in the actual amounts of the benchmark or any other relevant metric is less than 10%, additional analysis is not necessary for the re-evaluation when no other changes in circumstances have occurred.

When re-evaluating materiality, we determine the materiality amount that would have been established if the circumstances that exist as of the time of the re-evaluation and the actual amounts of the benchmark and other relevant metrics were known to us when we originally established materiality. Once we determine this amount, we then decide whether to revise materiality.

When do we revise materiality downwards? [ISA | 945.1300]

Once we determine the materiality amount that we would have established if the circumstances that exist as of the time of the re-evaluation and the actual amounts of the benchmark and other relevant metrics were known to us when we originally established materiality, we use the following guidelines to determine whether to revise materiality:

Results of our re-evaluation indicate a decrease of:	Impact to materiality
20% or more	Revise materiality to the amount indicated by our re-evaluation
10% but less than 20%	Consider revising materiality to the amount indicated by our re-evaluation and if not revised, document our rationale and consult with DPP
Less than 10%	Do not revise materiality

When we revise materiality downwards, we document the revised amount based on our re-evaluation and the factors considered in reaching that conclusion.

When may we increase materiality? [ISA | 945.158712]

We may increase materiality if our re-evaluation indicates an increase to materiality is appropriate. We use the revised materiality for purposes of evaluating audit results, which includes evaluating audit misstatements and the severity of control deficiencies.

Depending upon the timing of our re-evaluation, even though we believe a higher materiality is appropriate, we may decide not to increase performance materiality because we have obtained sufficient appropriate audit evidence using the initial lower performance materiality. In this circumstance, we document why we used our initial performance materiality.

Do we always re-evaluate materiality? [ISA | 945.11796]

Yes. We evaluate whether our preliminary considerations and conclusions about materiality are still appropriate - even when we are not aware of any specific changes in circumstances.

1.1.1 Consider whether changes in circumstances have occurred [ISA | 946]

What do we do?

Consider whether there are new circumstances or changes in circumstances that may impact materiality

Why do we do this?

When we establish materiality as part of planning, we consider both known events and events that are likely to occur. As the audit progresses, changes in circumstances are likely to occur, which could affect the users' perceptions of the entity. We therefore re-evaluate materiality and revise it as necessary.

Re-evaluating materiality helps us confirm we have established materiality at a level that:

- is appropriate for the circumstances, and
- allows us to perform appropriate and sufficient audit procedures.

Execute the Audit

What do we consider as a change in circumstances when re-evaluating our established materiality levels? [ISA | 946.1400]

There is no comprehensive list of changes in circumstances. Rather, we consider the factors that we initially considered in establishing materiality and whether there are any new factors or changes to factors to consider.

Examples of changes in circumstances include:

Examples of changes in circumstances	Potential impact to our re-evaluation of materiality
Change in ownership occurred during the period	• May impact our consideration of the qualitative factor 'ownership structure'
New debt arrangements or modification of debt covenants	• May result in the identification of a relevant metric not previously identified • May impact our consideration of the qualitative factor 'debt arrangements'
Sudden downturn in the business	• May impact our consideration of the qualitative factor 'business environment'

	• May impact the value of metrics uses in our initial assessment
New legal or regulatory changes in the industry in which the entity operates	• May result in the identification of a relevant metric not previously identified • May result in the determination of a specific benchmark or percentage of the benchmark due to regulatory requirements • May impact our consideration of the qualitative factor 'business environment'

When we identify a change in circumstances, do we always change materiality? [ISA | 946.1600]

No. When we identify a change in circumstances, we evaluate whether it is likely to change the judgment of the users. In some cases, we may determine that a change would have little effect on their judgment and our materiality. In other cases, we may determine that the effect could be significant (see question 'In what circumstances do we revise materiality?' for further information).

Changes in circumstance include events we expected to happen when establishing our initial materiality measure that may no longer be expected to occur.

1.1.2 Determine the actual amount of the relevant metrics, including the benchmark [ISA | 947]

What do we do?

Determine the actual amount of the metrics, including the benchmark and compare to the amounts of the relevant metrics used when initially establishing materiality

Why do we do this?

We re-evaluate materiality using the actual amounts of the relevant metrics, including the benchmark, so that materiality reflects the actual financial statements.

Execute the Audit

When do we update the amounts of the relevant metrics when we re-evaluate materiality? [ISA | 947.1300]

When we become aware of circumstances that indicate one or more metrics including the benchmark will be significantly different to that used in setting the initial materiality, we update these amounts and consider revising materiality. Revising materiality during the audit enables us to revise out audit plan appropriately. Due to the impact on our audit plan, we re-evaluate materiality when we become aware of these circumstances.

In addition at the end of the audit, we use the actual amounts of the relevant metrics, including the benchmark.

How do we determine the actual amount of the metrics, including the benchmark? [ISA | 947.1400]

We use the final financial statement amounts to determine the actual amount of the relevant metrics, including the benchmark.

We also:

- Adjust the relevant metrics, including the benchmark (see activity 'Adjust the relevant metrics, including the benchmark, when appropriate' for further information);
- include corrected misstatements; and
- include uncorrected misstatements when their inclusion may indicate a revision to materiality (see activity 'Revise materiality in certain circumstances' for further information)

What do we compare the amounts of the relevant metrics to when re-evaluating materiality? [ISA | 947.1500]

We compare the amounts of the relevant metrics we used to establish materiality to the actual amounts of the relevant metrics.

We also compare materiality as a percentage of the actual amounts for relevant metrics to materiality as a percentage of the amounts of the relevant metrics we used to establish materiality and assess the appropriateness of our initially established materiality as a percentage of actual amounts of the relevant metrics, including the benchmark.

If based upon our comparison, the actual amounts of the relevant metrics indicate a materiality that is 'significantly different,' we consider whether to revise materiality (see activity 'Revise materiality in certain circumstances' for further information).

What do we consider to be 'significantly different' when re-evaluating materiality?

'Significantly different' is a matter of judgment. However, we consider a decrease to materiality greater than 10% as "significantly different."

1.1.3 Revise materiality in certain circumstances [ISA | 948]

What do we do?

IF our re-evaluation indicates that materiality is not appropriate, THEN revise materiality

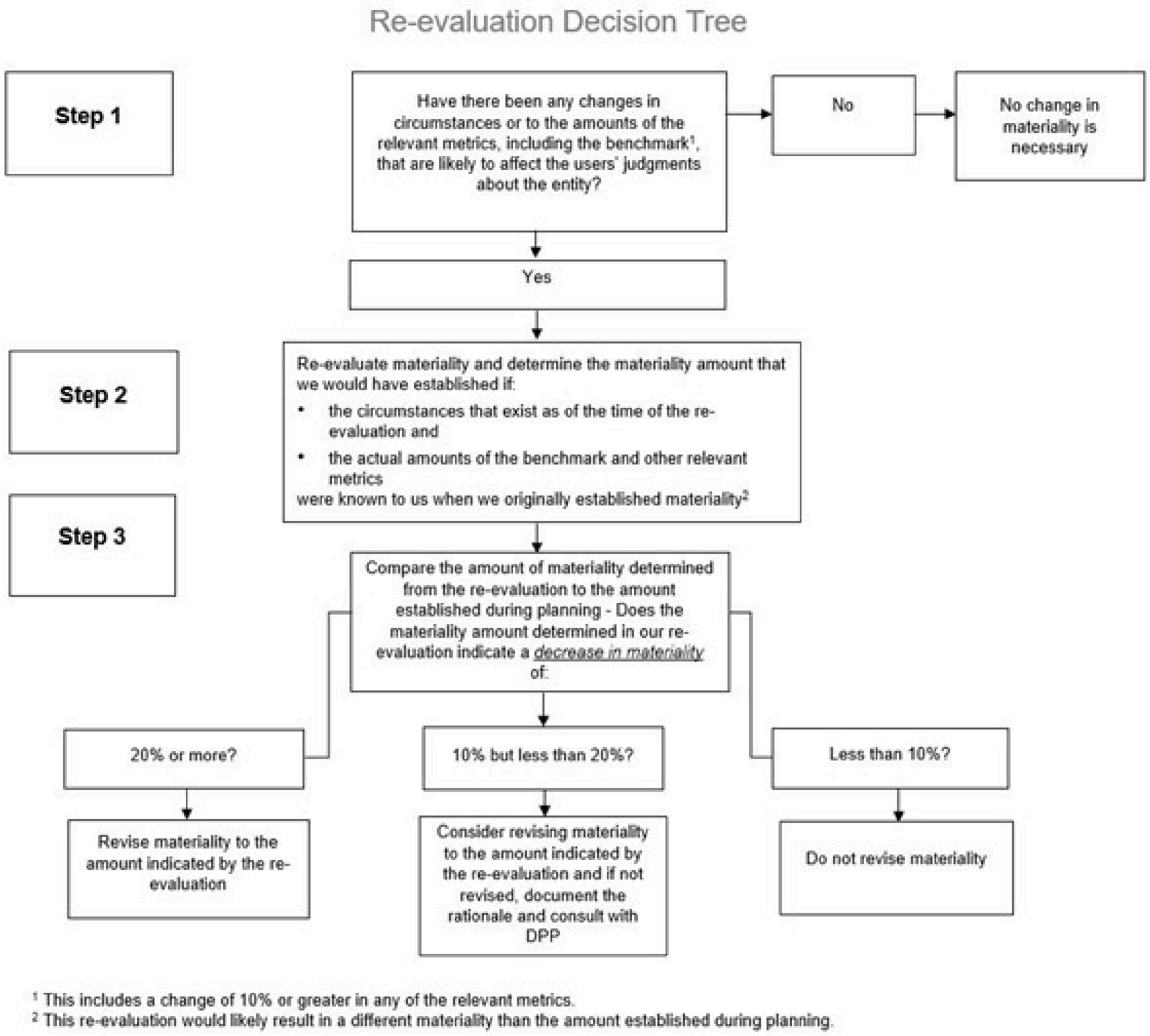
Why do we do this?

When we establish materiality as part of planning, we consider both known events and events that are likely to occur. As the audit progresses, changes in circumstances are likely to occur that would affect the users' perceptions of the entity as well changes to the amounts of the relevant metrics. We revise materiality, in order to perform appropriate and sufficient audit procedures to provide the basis for our opinion.

Execute the Audit

How do we determine whether to revise materiality? [ISA | 948.1301]

The following flowchart illustrates the steps to re-evaluate materiality and determine if it is



revised:

When do we revise materiality downwards? [ISA | 948.1300]

Once we determine the materiality amount that we would have established if the circumstances that exist as of the time of the re-evaluation and the actual amounts of the benchmark and other relevant metrics were known to us when we originally established materiality, we use the following guidelines to determine whether to revise materiality:

Results of our re-evaluation indicate a decrease of:	Impact to materiality
20% or more	Revise materiality to the amount indicated by our re-evaluation
10% but less than 20%	Consider revising materiality to the amount indicated by our re-evaluation and if not

	revised, document our rationale and consult with DPP
Less than 10%	Do not revise materiality

When we revise materiality downwards, we document the revised amount based on our re-evaluation and the factors considered in reaching that conclusion.

When may we increase materiality? [ISA | 948.158712]

We may increase materiality if our re-evaluation indicates an increase to materiality is appropriate. We use the revised materiality for purposes of evaluating audit results, which includes evaluating audit misstatements and the severity of control deficiencies.

Depending upon the timing of our re-evaluation, even though we believe a higher materiality is appropriate, we may decide not to increase performance materiality because we have obtained sufficient appropriate audit evidence using the initial lower performance materiality. In this circumstance, we document why we used our initial performance materiality.

How do we determine the revised materiality amount for the financial statements as a whole at the end of the audit? [ISA | 948.11799]

We perform the following steps that we performed when we initially established materiality for the financial statements as a whole:

(1) Identify the relevant metrics, including the benchmark
(2) Determine the amounts of the relevant metrics, including the benchmark
(3) Establish materiality as a specified amount

However, we use the actual amounts of the metrics (see activity 'Determine the actual amount of the relevant metrics, including the benchmark').

When we do not revise materiality, do we re-evaluate other materiality measures? [ISA | 948.11800]

Yes, there may be other circumstances when we re-evaluate other materiality measures that have nothing to do with materiality. For example, a change in our assessment of aggregation risk when determining whether to revise performance materiality.

Examples

When is it appropriate to revise materiality? [ISA | 948.11801]

Scenario A: Loss of major customer

After we established materiality and before period end, the entity loses a major customer, significantly reducing revenues and PBTCO. No other significant changes in circumstances occurred that would alter the factors and related metrics that are most important to the users. Our re-evaluation of materiality indicates a decrease to materiality of 25%.

In this situation, we revise materiality downward.

Scenario B: New law or regulation

After we established materiality and before period end, a new regulation was enacted that now requires the entity to maintain a minimum ratio of total liabilities to total assets. The relevant metrics identified were PBTCO (the benchmark), total revenues, and total assets.

In this situation, we consider how this change in circumstances affects the factors and relevant metrics. To the extent the new regulation increases the importance of total assets and/or total liabilities, we may determine that total liabilities is also a relevant metric. We may also consider whether it is necessary to decrease materiality in relation to total assets based on the new regulation.

Based upon the materiality established in our re-evaluation, we consider whether it is necessary to revise materiality and consult with DPP as appropriate.

Scenario C: Disposal of a business

After we established materiality and before period end, the entity's board of directors approve a plan to sell a line of business. The sale represents a strategic shift to the entity and will significantly affect the entity's operations and financial position. The entity therefore decided to account for this line of business as discontinued operations. Previously, no discontinued operations existed. Our re-evaluation of materiality indicates a decrease to materiality of 15%.

In this situation, we consider how this change in circumstances will affect the factors and relevant metrics, and we consider whether to revise materiality downward to reflect the decrease in revenues, PBTCO and assets attributable to the discontinued operations. If we do not revise materiality in this scenario, we consult with DPP.

1.2 Determine whether to revise lower materiality for particular accounts or disclosures [ISA | 7630]

What do we do?

Determine whether to revise lower materiality for particular accounts or disclosures

Why do we do this?

We ordinarily establish materiality and other materiality measures before the end of the period under audit. After these are established, events may occur and/or conditions may change or in performing the audit of the financial statements we have more accurate information about the entity that might affect our assessment.

Re-evaluating materiality for particular accounts and disclosures enables us to establish materiality at a level that is appropriate for the circumstances and to perform appropriate and sufficient audit procedures to identify a material misstatement over those particular accounts or disclosures.

Execute the audit

How do we determine whether to revise materiality when we have established materiality as lower for a particular account or disclosure? [ISA | 7630.11784]

Similar to re-evaluating materiality for the financial statements as a whole, we also re-evaluate materiality for a particular account or disclosure. We follow a similar process (see question 'How do we re-evaluate materiality for the financial statements as a whole?' for further information), but we look at the particular account rather than the financial statements as a whole.

We also re-evaluate whether:

- misstatements smaller than initial materiality in the account or disclosure would be material to the users; and
- it is appropriate to lower materiality for any additional accounts or disclosures.

For example, an entity had a significant acquisition during the year. Users of the financial statements have paid particular attention to amounts disclosed related to the business combination such that the engagement team may determine to establish a lower materiality for the disclosure related to the business combination.

When we revise materiality for a particular account or disclosure, we document the revised amount and the factors considered in reaching that conclusion. Our documentation may also include why the change does not affect our considerations of materiality for the financials as a whole.

1.3 Determine whether to revise performance materiality [ISA | 949]

What do we do?

Determine whether to revise performance materiality

Why do we do this?

Similar to the way we re-evaluate materiality throughout the audit, we re-evaluate whether our initial performance materiality is still appropriate. This allows us to plan and perform appropriate procedures to reduce aggregation risk and ultimately audit risk to an appropriate level.

Execute the Audit

How do we determine whether to revise performance materiality? [ISA | 949.1300]

Whenever we change our assessment of the level of aggregation risk or revise materiality, a change to performance materiality may be appropriate.

As such, in order to determine whether to revise performance materiality, we:

- re-assess the level of aggregation risk;
- re-assess performance materiality as a percentage of final materiality (revised as appropriate); and
- revise performance materiality in certain circumstances

1.3.1 Re-assess the level of aggregation risk [ISA | 950]

What do we do?

IF we identify indicators of a change in the level of aggregation risk, re-assess the level of aggregation risk as Normal, Increased or High

IF we identify indicators of a change in the level of aggregation risk, re-assess the level of aggregation risk as Low, Normal, Increased or High.

Why do we do this?

During the audit, we may identify changes in the entity or get more information about the entity that indicates the aggregation risk we determined in planning is no longer appropriate and has increased. When we initially assessed aggregation risk, we considered historical knowledge and anticipated that past results would reflect future results. However, this assessment may not be accurate based on actual results - e.g. due to a greater number of misstatements detected, control deficiencies or turnover in personnel.

Execute the Audit

Enhanced | How do we re-assess the level of aggregation risk when we determine whether we revise performance materiality? [ISA | 950.11772]

Similar to what we used at planning, we consider the factors that affect aggregation risk (see activity 'Consider the factors that affect aggregation risk' for further information) and continue to use a tiered approach to assess the level of aggregation risk as either Normal, Increased, or High (see activity 'Assess the level of aggregation risk' for further information).

When considering these factors, we take into account the results of our procedures and information obtained throughout the audit, such as known misstatements and deficiencies identified in the current year and our other observations about the entity, such as changes to the management team. Based on this re-assessment, we determine whether to revise our initial level of aggregation risk.

Core and Less Complex | How do we re-assess the level of aggregation risk when we determine whether we revise performance materiality? [ISA | 950.8974]

Similar to what we used at planning, we consider the factors that affect aggregation risk (see activity 'Consider the factors that affect aggregation risk' for further information) and continue to use a tiered approach to assess the level of aggregation risk as either Low, Normal, Increased, or High (see activity 'Assess the level of aggregation risk' for further information).

When considering these factors, we take into account the results of our procedures and information obtained throughout the audit, such as known misstatements and deficiencies identified in the current year and our other observations about the entity, such as changes to the management team. Based on this re-assessment, we determine whether to revise our initial level of aggregation risk.

What if we revise the level of aggregation risk? [ISA | 950.11773]

If we revise the level of aggregation risk based upon our re-assessment, we next consider whether a revision to performance materiality is necessary (see activity 'Revise performance materiality in certain circumstances'). Our revised level of aggregation risk will be used in determining the appropriateness of performance materiality (see activity 'Re-assess performance materiality as a percentage of final materiality' for further information).

Examples

When do we change our assessment of aggregation risk? [ISA | 950.11774]

Fact pattern

The engagement team is auditing an entity in the for-profit technology industry. They have audited this entity for a number of years. As part of the engagement team's planning, they note that the entity had:

- an effective control environment;
- few, if any, misstatements identified historically;
- no uncorrected misstatements in prior periods;
- no management turnover and
- a strong tone at the top.

The team expects these past results to continue in the current period and assess the level of aggregation risk at Normal.

During the audit, the engagement team notes an increase in turnover of senior management, identifies several control deficiencies in the revenue and billing process and identifies audit misstatements that impact several accounts that were corrected by the entity.

Analysis

When taking into account the matters identified during the audit, the engagement team determines that the level of aggregation risk has increased from their original assessment and revises the level of aggregation risk to Increased.

1.3.2 Re-assess performance materiality as a percentage of final materiality [ISA | 952]

What do we do?

IF we revised materiality for the financial statements as a whole, re-assess performance materiality as a percentage of final materiality and revise when appropriate

Why do we do this?

When materiality decreases or our assessment of aggregation risk changes, performance materiality may no longer be at the appropriate amount to sufficiently reduce our audit risk to an appropriate level.

Execute the Audit

Enhanced | What percentages do we use to re-assess performance materiality as a percentage of final materiality? [ISA | 952.6247]

Based upon our updated assessment of aggregation risk (see activity 'Re-assess the level of aggregation risk' for further information), we determine whether performance materiality remains appropriate. In doing so, we use the following percentages:

When aggregation Risk is assessed as:	Performance materiality does not exceed:
Normal	75% of materiality
Increased	65% of materiality
High	50% of materiality

Core and Less Complex | What percentages do we use to re-assess performance materiality as a percentage of final materiality? [ISA | 952.9003]

Based upon our updated assessment of aggregation risk (see activity 'Re-assess the level of aggregation risk' for further information), we determine whether performance materiality remains appropriate. In doing so, we use the following percentages:

When aggregation Risk is assessed as:	Performance materiality does not exceed:
Low	85% of materiality
Normal	75% of materiality
Increased	65% of materiality
High	50% of materiality

What do we do if we exceed the percentages? [ISA | 952.11775]

If we exceed the percentage of final materiality for the final aggregation risk level, we revise performance materiality (see 'Revise materiality in certain circumstances' for additional information).

1.3.3 Revise performance materiality in certain circumstances [ISA | 951]

What do we do?

IF the level of aggregation risk has changed OR performance materiality exceeds a certain percentage of final materiality THEN revise performance materiality

Why do we do this?

When aggregation risk increases or materiality decreases, performance materiality may no longer be at the appropriate amount to sufficiently reduce our aggregation risk and therefore audit risk to an appropriate level.

Execute the Audit

When do we revise performance materiality or other materiality measures? [ISA | 951.11809]

We revise performance materiality when:

- we revise aggregation risk from our original assessment (see activity 'Re-assess the level of aggregation risk' for further information) and it increased; or
- we revise materiality for the financial statements as a whole and performance materiality as a percentage of final materiality exceeds certain thresholds (see question 'What percentages do we use to re-assess performance materiality as a percentage of final materiality?').

How do we revise performance materiality? [ISA | 951.11810]

When we revise performance materiality, we follow a similar process to the process we used when determining performance materiality initially. To revise performance materiality, we:

- determine the revised performance materiality amount considering our assessment of the level of aggregation risk (revised for any new information and changes in circumstances); and
- document the considerations made and our rationale for revising performance materiality.

Examples

How do we revise performance materiality in response to a change in aggregation risk? [ISA | 951.1800]

Fact pattern

The engagement team initially established materiality for the financial statements as a whole using estimated amounts. Based on history, they assessed aggregation risk as Normal and established performance materiality at the appropriate percentage of materiality.

During the third quarter, the engagement team re-assessed materiality, considering updated estimates of the metrics, and concluded that materiality remained appropriate.

Analysis

When re-assessing performance materiality, the engagement team considers the following factors that drive our assessment of aggregation risk.

Factor considered	Reassessment result
Effectiveness of the entity's control environment	Based on testing to date, the entity's control environment is effective
Number of internal control deficiencies and level of deficiency	Based on testing to date, we identified an increase in control deficiencies but none

	stem from a significant deficiency or material weakness
History of misstatements accumulated in audits of the financial statements of prior periods (corrected and uncorrected)	The company had few misstatements in prior periods, but the engagement team has identified that there is an increase in misstatements in the current year.
Level of turnover of senior management or key financial reporting personnel	Key financial reporting personnel have turned over in the current year
Management's preparedness and willingness to correct misstatements	Management is willing to correct any identified misstatements
Proportion of accounts not identified as significant accounts	A small proportion of accounts are identified as not significant

Outcome

After considering these factors, the engagement team determines that aggregation risk is more appropriately assessed at Increased. The engagement team determines that revising performance materiality to 65% of materiality is appropriate. The engagement team then evaluates the effect of lowering performance materiality to the audit.

1.4 Determine whether to revise lower performance materiality for particular accounts or disclosures [ISA | 7631]

What do we do?

Determine whether to revise lower performance materiality for particular accounts or disclosures

Why do we do this?

Similar to the way we re-evaluate materiality for particular accounts or disclosures, we re-evaluate whether our initial performance materiality for particular accounts or disclosures is appropriate. This allows us to plan and perform appropriate procedures to reduce our audit risk for particular accounts or disclosures to an appropriate level.

Execute the audit

When do we revise performance materiality for a particular account or disclosure? [ISA | 7631.11786]

Whenever we change our assessment of the level of aggregation risk or revise materiality for a particular account or disclosure, a change to performance materiality may be necessary.

As such, in order to determine whether to revise performance materiality for a particular account or disclosure, we:

- re-assess aggregation risk;
- re-assess performance materiality as a percentage of materiality (revised as appropriate) and
- revise performance materiality for a particular account or disclosure as necessary.

Similar to the financial statements as a whole, whether we revise performance materiality for a particular account or disclosure depends on the facts and circumstances of the entity related to that particular account or disclosure.

The only difference for performance materiality for a particular account and the financial statements as a whole is that we consider the facts and circumstances at the particular account or disclosure level and not the financial statements as a whole.

When we revise performance materiality for a particular account or disclosure, we document the revised amount and the factors considered in reaching that conclusion.

Enhanced | What percentages do we use to re-assess performance materiality for a particular account or disclosure? [ISA | 7631.6248]

Based upon our updated assessment of aggregation risk, we determine whether performance materiality for a particular account or disclosure remains appropriate. In doing so, we use the following percentages:

When aggregation risk for the particular account or disclosure is assessed as:	Performance materiality for the particular account or disclosure does not exceed:
Normal	75% of the lower materiality for the particular account or disclosure
Increased	65% of the lower materiality for the particular account or disclosure
High	50% of the lower materiality for the particular account or disclosure

Core and Less Complex | What percentages do we use to re-assess performance materiality for a particular account or disclosure? [ISA | 7631.9004]

Based upon our updated assessment of aggregation risk, we determine whether performance materiality for a particular account or disclosure remains appropriate. In doing so, we use the following percentages:

When aggregation risk for the particular account or disclosure is assessed as:	Performance materiality for the particular account or disclosure does not exceed:
Low	85% of the lower materiality for the particular account or disclosure
Normal	75% of the lower materiality for the particular account or disclosure
Increased	65% of the lower materiality for the particular account or disclosure
High	50% of the lower materiality for the particular account or disclosure

2 Evaluate the effect of revised materiality and performance materiality on the audit [ISA | 954]

What do we do?

Evaluate the effect, if any, of the lower revised materiality and/or revised performance materiality on risk assessments and audit procedures AND modify the nature, timing and extent of audit procedures as necessary

Why do we do this?

When we re-evaluate materiality and performance materiality and determine a lower amount, we then determine the effect on:

- our risk assessments
- our audit procedures, including nature, timing, and extent
- our evaluation of uncorrected misstatements.

This enables us to determine whether we have:

- performed an appropriate risk assessment; or
- designed our procedures to sufficiently reduce our audit risk to an appropriate level.

In these circumstances, we consider what additional work is necessary.

Execute the Audit

What is the impact to our audit when we revise materiality for the financial statements as a whole? [ISA | 954.1300]

When we revise materiality, it can impact one or many of the following:

- component materiality
- our group scoping decisions, including our evaluation of remaining financial information in a group audit
- audit misstatement posting threshold
- conclusions about whether the precision level of process control activities is appropriate
- conclusions reached on severity of control deficiencies
- conclusions reached on uncorrected misstatements

What is the effect on the appropriateness of the precision level of controls when we revise materiality? [ISA | 954.2100]

If our materiality decreases, we may have initially concluded that controls were designed appropriately that are no longer sufficiently precise to prevent or detect a material misstatement.

When we evaluate the design of controls, we evaluate the level of precision at which the control operates. The level of precision indicates what size of misstatement the control would prevent or detect. As part of our test of design, we evaluate whether the controls were sufficiently precise to prevent or detect a material misstatement individually or in the aggregate (i.e., greater than materiality).

If controls we evaluated are no longer sufficiently precise to prevent or detect a material misstatement, we either identify additional controls that operate at an appropriate precision level or identify a control deficiency and assess control risk at the maximum.

How are our conclusions on the severity of a deficiency affected by lower materiality? [ISA | 954.2200]

If we performed our evaluation of severity of a deficiency before we revised materiality, we may have considered the likelihood and potential magnitude of misstatements that could result from the deficiency in comparison to a materiality level that is too high. If we lower materiality, our assessment of the severity may also be different, resulting in us identifying a significant deficiency or material weakness.

How are our conclusions on uncorrected misstatements affected? [ISA | 954.2300]

If we revise materiality downward, we may now conclude that the uncorrected misstatements represent a material amount to the financial statements, which could impact our audit report.

What is the impact to our audit when we revise performance materiality? [ISA | 954.11940]

When we revise performance materiality, the impact to our audit includes:

- our assessment of risks of material misstatement, including our identification of significant accounts and disclosures and their relevant assertions
- the procedures we plan and perform (e.g. the appropriateness of precision of our substantive analytical procedure, determination of our sample sizes, conclusions about the level of evidence necessary to conclude, etc.), including the determination of sub-population performance materiality (see activity 'Determine SPM if applicable' for further information)

What is the effect of revising performance materiality on sub-population performance materiality? [ISA | 954.2000]

Since we use performance materiality to determine sub-population performance materiality, when we lower our performance materiality, we also adjust our sub-population performance materiality measures and determine the impact to our substantive audit procedures.

What if performance materiality increases from what we initially determined? [ISA | 954.11941]

When performance materiality increases from what we initially determined, we do not remove any of the testing and related results already performed.

Do we wait until the end of field work to perform this analysis? [ISA | 954.1400]

No. Materiality and performance materiality affect so many of our decisions and results that we perform this analysis as soon as we revise either of them. If we don't do this timely, we may not have enough time to plan and perform additional procedures.

When do we involve the EQCR or LSQCR when materiality or performance materiality may change? [ISA | 954.2400]

When an EQCR or LSQCR is appointed, we involve the engagement quality control reviewer (EQCR) or limited scope quality control reviewer (LSQCR), as soon as we identify indicators that materiality or performance materiality may change. Materiality and performance materiality have a pervasive effect to our audit plan and the judgments we make in the audit.

We therefore discuss these matters timely with the EQCR or LSQCR, as well as the effects that we expect on both the planned procedures and procedures we already performed.

Documentation

International Standards on Auditing: ISA 320.14

Documentation

14. The auditor shall include in the audit documentation the following amounts and the factors considered in their determination:[5]

(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); and

(d) Any revision of (a)-(c) as the audit progressed (see paragraphs 12-13).

5 ISA 230, *Audit Documentation,* paragraphs 8 - 11, and A6

How do we comply with the Standards? [ISA | KAEGHDWC]

1 Establish materiality as a specified amount [ISA | 933]

What do we do?

Establish materiality for the financial statements as a whole, expressed as a specified amount

Why do we do this?

Although materiality is a concept, it is not practical to design audit procedures and evaluate audit misstatements without establishing materiality as a specified amount. Materiality is not a calculation but rather a judgment we make based on quantitative and qualitative factors to arrive at a specified amount.

Execute the Audit

How do we establish materiality as a specified amount? [ISA | 933.1300]

To establish materiality as a specified amount, we:

- Consider the influence of qualitative factors
- Assess the appropriateness of materiality as a percentage of the relevant metrics, including the benchmark
- Assess whether materiality is appropriate compared to the prior audit

We express materiality as a whole amount rounded to three significant digits and document the factors considered in our determination.

US GAAP | How do we establish materiality if we are auditing predecessor/ successor period financial statements from the application of pushdown accounting in a business combination? [ISA | 933.11767]

We use the same process to establish materiality when we audit financial statements that includes predecessor/successor periods from the application of pushdown accounting in a business combination. We consider the users when determining the relevant factors and metrics.

We determine the purpose for the presentation in the predecessor/successor financial statements, and how the users use these financial statements to make judgments. This helps us understand what is important to the users.

For certain metrics - typically income statement metrics - the users may view the predecessor period as discontinued operations, because the nature of the business has changed significantly post-business combination. This would cause us to put less weight on the predecessor period. However, in other circumstances, the users may consider the predecessor and successor periods together.

Based on the above considerations, we establish materiality for each period presented. We may also identify certain accounts in either or both of the predecessor or successor financial statements, in which a smaller misstatement may influence the judgments of the users. In that case, we could establish a lower materiality for those particular accounts (see activity 'Determine whether to establish a lower materiality for particular accounts or disclosures ').

2 Determine whether to establish a lower materiality for particular accounts or disclosures [ISA | 939]

What do we do?

Determine whether there are particular accounts or disclosures for which we establish a lower materiality AND the amount of the lower materiality, when applicable.

Why do we do this?

We establish a materiality level for the financial statements as a whole. But we also identify accounts or disclosures where misstatements smaller than the materiality for the financial statements as whole would be considered material.

This will enable us to plan and perform appropriate procedures and to identify a material misstatement over those particular accounts or disclosures that users are particularly sensitive to.

Execute the Audit

Which particular accounts or disclosures do we establish a lower materiality for? [ISA | 939.1300]

We establish a lower materiality for particular accounts or disclosures for which there is a 'substantial likelihood,' or 'a reasonable expectation' that a misstatement smaller than the materiality for the financial statements as whole would be considered material to the users of the financial statements (see question 'Where may we obtain information to determine what is important to users?' for sources of information that may help us identify those particular accounts or disclosures).

It is not common to identify particular accounts or disclosures for which we establish a lower materiality.

How do we apply the terms 'substantial likelihood' and 'reasonable expectation'? [ISA | 939.1600]

We consider whether the users of the financial statements would place a level of importance on a misstatement within a particular account or disclosure that:

- is lower than our materiality for the financial statements as a whole; and
- would merit a lower materiality being applied to that account or disclosure.

We use our judgment to determine what accounts or disclosures meet this threshold.

What factors may think about when determining whether to establish a lower materiality for particular accounts or disclosures? [ISA | 939.2000]

Similar to materiality for the financial statements as a whole, each entity will be specific to the entity in terms of its relevant factors. However, we think about the following factors.

Factor	Example
Whether law, regulation or the applicable financial reporting framework affect users' expectations regarding the measurement or disclosure of certain items	• Related party transactions - There is usually more sensitivity surrounding related party transactions and whether there is a conflict of interest. • Compensation of management and those charged with governance (TCWG) - There may be more sensitivity surrounding the disclosure of compensation of management and TCWG. • Sensitivity analysis for fair value accounting estimates with high estimation uncertainty (a

	misstatement in the sensitivity analysis may influence users' judgments, in addition to the fair value accounting estimate itself).
The key disclosures in relation to the industry in which the entity operates	Research and development costs for a pharmaceutical company - Users may use this as a leading indicator of future results to help identify if new products are on the horizon.
Whether attention is focused on a particular aspect of the entity's business that is separately disclosed in the financial statements	Disclosures about segments or a significant business combination.

How do we determine the lower materiality amount for particular accounts or disclosures? [ISA | 939.1800]

Similar to the process we used to establish materiality for the financial statements as a whole, we consider quantitative and qualitative factors that are specific to those particular accounts or disclosures. We document the amount of the lower materiality for particular accounts and disclosures and the factors considered when determining the amount.

Do we consider aggregation risk when determining a lower materiality amount? [ISA | 939.2300]

No. We consider aggregation risk when we determine our performance materiality (sometimes referred to as 'tolerable misstatement').

Group Audit | How do we determine whether to establish a lower group materiality for particular accounts or disclosures? [ISA | 939.159839]

As the group auditor, we determine whether to establish a lower group materiality for particular accounts or disclosures in the same way as in a stand-alone audit, but consider the amounts from the consolidated financial statements.

Examples

How do we determine a lower materiality for a particular account or disclosure? [ISA | 939.11529]

Scenario 1 | Lower materiality for a particular account or disclosure is appropriate

Fact pattern:

The engagement team is auditing a bond fund, and establishing materiality as part of their planning. The fund offers professional selection and management of a portfolio of fixed-income securities. Investors buy shares in the bond fund based on the net asset value (NAV). The NAV is calculated by dividing the fund's total assets by the number of shares outstanding. In addition, the fund makes money from the interest earned on the securities it owns or by selling those securities at a profit. The fund distributes dividends based on these earnings.

The engagement team established materiality after considering net assets, PBTCO and total assets.

Analysis:

The engagement team noted that the amount of dividends distributed to the investors was based on the interest earned. While the value of the funds was determined by the NAV, investors considered the dividends received when making judgments. The team noted in industry reports that analysts discussed the amount of dividends various funds produced. As a result, the engagement team determined that a smaller misstatement in the interest earned account would be material to the users. Therefore, they determined a lower materiality for the interest earned account.

Scenario 2 | Lower materiality for a particular account or disclosure is appropriate

Fact pattern:

The engagement team is auditing a consumer product entity, and establishing materiality as part of their planning.

The entity produces different products by segment, and discloses the revenue per segment in the footnotes. In the current period, the entity has introduced a new product that it believes will become the market leader and will become the most significant product it sells in the future. The entity does not come out with products every year or two; this is a seminal change for the entity.

The engagement team reviews press releases, analyst reports and internal documentation, and notes that the product is often discussed when evaluating the entity's performance.

The engagement team establishes materiality after considering revenue, PBTCO and total assets.

Analysis:

The users were focused on the revenue growth in this product when they valued the entity. Although the revenue for the product was not a significant portion of the total revenue in the current period, the trend was significant to the users.

As a result, the engagement team determines that a smaller misstatement in that product segment revenue would be material the users. Therefore, the engagement team establishes a lower materiality for that segment revenue account.

3 Determine an amount for performance materiality [ISA | 943]

What do we do?

Determine performance materiality as an amount and, if applicable, a lower performance materiality amount for particular accounts and disclosures

Why do we do this?

Once we have evaluated the factors and determined our level of aggregation risk, we determine a performance materiality (PM) amount. This enables us to:

- assess risks of material misstatement (RMMs); and
- plan and perform our audit procedures.

Execute the Audit

Enhanced | How do we determine performance materiality as an amount? [ISA | 943.6245]

We determine performance materiality at the amount that reduces aggregation risk to an appropriately low level.

In doing so, we use the level of aggregation risk we assessed and determine the amount of performance materiality as follows:

When aggregation risk is assessed as:	Performance materiality is determined as:
Normal	75% of materiality
Increased	65% of materiality
High	50% of materiality

We document our determined performance materiality amount and the factors considered in our determination.

We express performance materiality as an amount that is rounded to three significant digits.

Core and Less Complex | How do we determine performance materiality as an amount? [ISA | 943.8972]

We determine performance materiality at the amount that reduces aggregation risk to an appropriately low level.

In doing so, we use the level of aggregation risk we assessed and determine the amount of performance materiality as follows:

When aggregation risk is assessed as:	Performance materiality is determined as:
Low	85% of materiality
Normal	75% of materiality
Increased	65% of materiality
High	50% of materiality

We document our determined performance materiality amount and the factors considered in our determination.

We express performance materiality as an amount that is rounded to three significant digits.

If a regulator requires a certain percentage of materiality, do we use that to determine performance materiality? [ISA | 943.1800]

If a regulator requires a certain percentage of materiality to determine performance materiality, we use that percentage as our maximum amount for performance materiality.

For example, if a regulator requires performance materiality be 40% of materiality, we would establish performance materiality as an amount that did not exceed 40% of materiality.

Enhanced | How do we determine performance materiality as an amount for particular accounts or disclosures? [ISA | 943.6246]

We determine performance materiality at the amount that reduces aggregation risk to an appropriately low level.

In doing so, we use the level of aggregation risk we assessed for the particular account or disclosure and determine the amount of performance materiality for particular accounts or disclosures as follows:

When aggregation risk for the particular account or disclosure is assessed as:	Performance materiality for the particular account or disclosure is determined as:
Normal	75% of the lower materiality for the particular account or disclosure
Increased	65% of the lower materiality for the particular account or disclosure
High	50% of the lower materiality for the particular account or disclosure

We document our determined lower performance materiality amount(s) and the factors considered in our determination.

Core and Less Complex | How do we determine performance materiality as an amount for particular accounts or disclosures? [ISA | 943.9005]

We determine performance materiality at the amount that reduces aggregation risk to an appropriately low level.

In doing so, we use the level of aggregation risk we assessed for the particular account or disclosure and determine the amount of performance materiality for particular accounts or disclosures as follows:

When aggregation risk for the particular account or disclosure is assessed as:	Performance materiality for the particular account or disclosure is determined as:
Low	85% of the lower materiality for the particular account or disclosure

Normal	75% of the lower materiality for the particular account or disclosure
Increased	65% of the lower materiality for the particular account or disclosure
High	50% of the lower materiality for the particular account or disclosure

We document our determined lower performance materiality amount(s) and the factors considered in our determination.

4 Revise materiality in certain circumstances [ISA | 948]

What do we do?

IF our re-evaluation indicates that materiality is not appropriate, THEN revise materiality

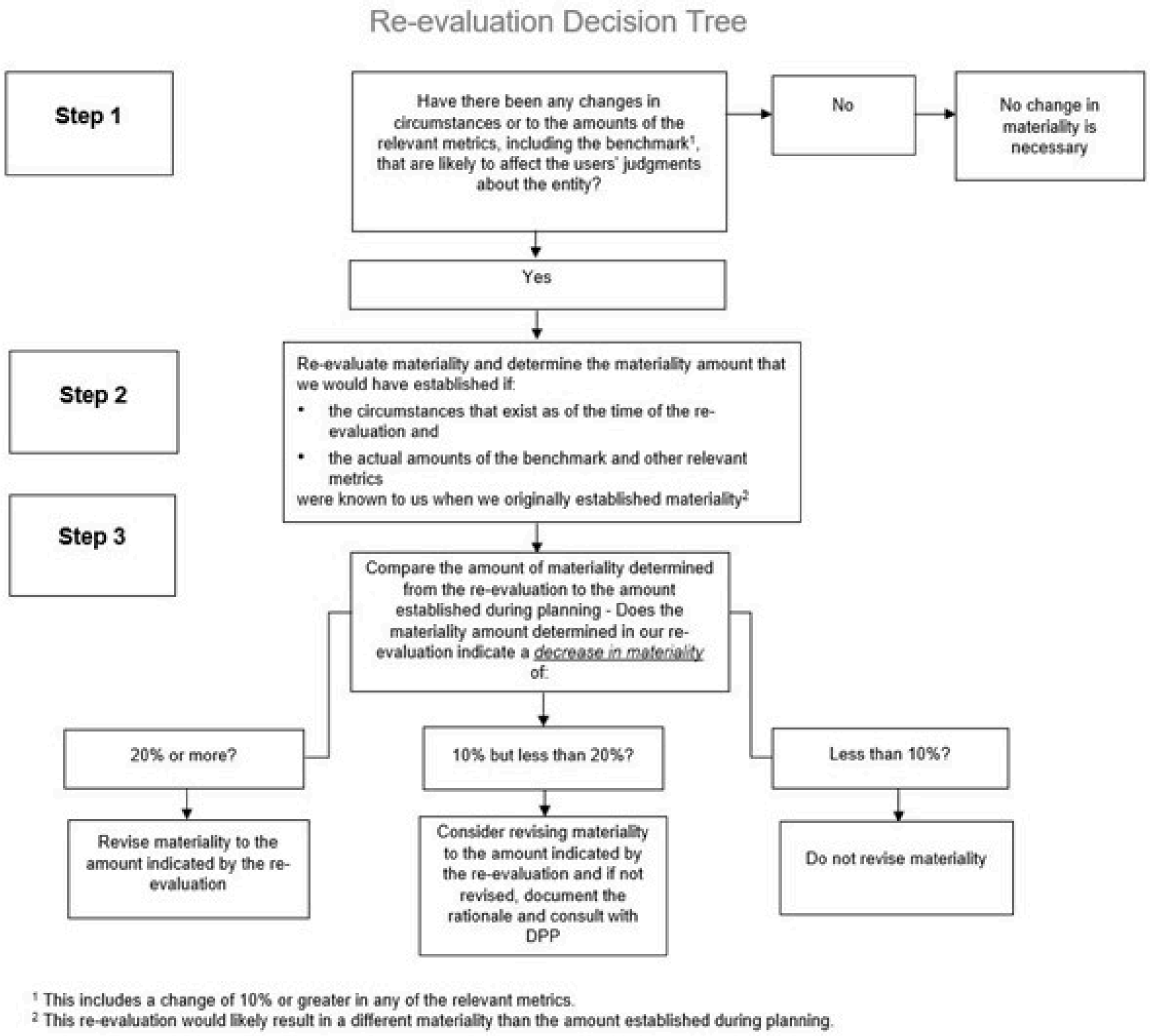
Why do we do this?

When we establish materiality as part of planning, we consider both known events and events that are likely to occur. As the audit progresses, changes in circumstances are likely to occur that would affect the users' perceptions of the entity as well changes to the amounts of the relevant metrics. We revise materiality, in order to perform appropriate and sufficient audit procedures to provide the basis for our opinion.

Execute the Audit

How do we determine whether to revise materiality? [ISA | 948.1301]

The following flowchart illustrates the steps to re-evaluate materiality and determine if it is



revised:

When do we revise materiality downwards? [ISA | 948.1300]

Once we determine the materiality amount that we would have established if the circumstances that exist as of the time of the re-evaluation and the actual amounts of the benchmark and other relevant metrics were known to us when we originally established materiality, we use the following guidelines to determine whether to revise materiality:

Results of our re-evaluation indicate a decrease of:	Impact to materiality
20% or more	Revise materiality to the amount indicated by our re-evaluation
10% but less than 20%	Consider revising materiality to the amount indicated by our re-evaluation and if not

	revised, document our rationale and consult with DPP
Less than 10%	Do not revise materiality

When we revise materiality downwards, we document the revised amount based on our re-evaluation and the factors considered in reaching that conclusion.

When may we increase materiality? [ISA | 948.158712]

We may increase materiality if our re-evaluation indicates an increase to materiality is appropriate. We use the revised materiality for purposes of evaluating audit results, which includes evaluating audit misstatements and the severity of control deficiencies.

Depending upon the timing of our re-evaluation, even though we believe a higher materiality is appropriate, we may decide not to increase performance materiality because we have obtained sufficient appropriate audit evidence using the initial lower performance materiality. In this circumstance, we document why we used our initial performance materiality.

How do we determine the revised materiality amount for the financial statements as a whole at the end of the audit? [ISA | 948.11799]

We perform the following steps that we performed when we initially established materiality for the financial statements as a whole:

(1) Identify the relevant metrics, including the benchmark
(2) Determine the amounts of the relevant metrics, including the benchmark
(3) Establish materiality as a specified amount

However, we use the actual amounts of the metrics (see activity 'Determine the actual amount of the relevant metrics, including the benchmark').

When we do not revise materiality, do we re-evaluate other materiality measures? [ISA | 948.11800]

Yes, there may be other circumstances when we re-evaluate other materiality measures that have nothing to do with materiality. For example, a change in our assessment of aggregation risk when determining whether to revise performance materiality.

Examples

When is it appropriate to revise materiality? [ISA | 948.11801]

Scenario A: Loss of major customer

After we established materiality and before period end, the entity loses a major customer, significantly reducing revenues and PBTCO. No other significant changes in circumstances occurred that would alter the factors and related metrics that are most important to the users. Our re-evaluation of materiality indicates a decrease to materiality of 25%.

In this situation, we revise materiality downward.

Scenario B: New law or regulation

After we established materiality and before period end, a new regulation was enacted that now requires the entity to maintain a minimum ratio of total liabilities to total assets. The relevant metrics identified were PBTCO (the benchmark), total revenues, and total assets.

In this situation, we consider how this change in circumstances affects the factors and relevant metrics. To the extent the new regulation increases the importance of total assets and/or total liabilities, we may determine that total liabilities is also a relevant metric. We may also consider whether it is necessary to decrease materiality in relation to total assets based on the new regulation.

Based upon the materiality established in our re-evaluation, we consider whether it is necessary to revise materiality and consult with DPP as appropriate.

Scenario C: Disposal of a business

After we established materiality and before period end, the entity's board of directors approve a plan to sell a line of business. The sale represents a strategic shift to the entity and will significantly affect the entity's operations and financial position. The entity therefore decided to account for this line of business as discontinued operations. Previously, no discontinued operations existed. Our re-evaluation of materiality indicates a decrease to materiality of 15%.

In this situation, we consider how this change in circumstances will affect the factors and relevant metrics, and we consider whether to revise materiality downward to reflect the decrease in revenues, PBTCO and assets attributable to the discontinued operations. If we do not revise materiality in this scenario, we consult with DPP.

5 Determine whether to revise lower materiality for particular accounts or disclosures [ISA | 7630]

What do we do?

Determine whether to revise lower materiality for particular accounts or disclosures

Why do we do this?

We ordinarily establish materiality and other materiality measures before the end of the period under audit. After these are established, events may occur and/or conditions may change or in performing the audit of the financial statements we have more accurate information about the entity that might affect our assessment.

Re-evaluating materiality for particular accounts and disclosures enables us to establish materiality at a level that is appropriate for the circumstances and to perform appropriate and sufficient audit procedures to identify a material misstatement over those particular accounts or disclosures.

Execute the audit

How do we determine whether to revise materiality when we have established materiality as lower for a particular account or disclosure? [ISA | 7630.11784]

Similar to re-evaluating materiality for the financial statements as a whole, we also re-evaluate materiality for a particular account or disclosure. We follow a similar process (see question 'How do we re-evaluate materiality for the financial statements as a whole?' for further information), but we look at the particular account rather than the financial statements as a whole.

We also re-evaluate whether:

- misstatements smaller than initial materiality in the account or disclosure would be material to the users; and
- it is appropriate to lower materiality for any additional accounts or disclosures.

> For example, an entity had a significant acquisition during the year. Users of the financial statements have paid particular attention to amounts disclosed related to the business combination such that the engagement team may determine to establish a lower materiality for the disclosure related to the business combination.

When we revise materiality for a particular account or disclosure, we document the revised amount and the factors considered in reaching that conclusion. Our documentation may also include why the change does not affect our considerations of materiality for the financials as a whole.

6 Revise performance materiality in certain circumstances [ISA | 951]

What do we do?

IF the level of aggregation risk has changed OR performance materiality exceeds a certain percentage of final materiality THEN revise performance materiality

Why do we do this?

When aggregation risk increases or materiality decreases, performance materiality may no longer be at the appropriate amount to sufficiently reduce our aggregation risk and therefore audit risk to an appropriate level.

Execute the Audit

When do we revise performance materiality or other materiality measures? [ISA | 951.11809]

We revise performance materiality when:

- we revise aggregation risk from our original assessment (see activity 'Re-assess the level of aggregation risk' for further information) and it increased; or
- we revise materiality for the financial statements as a whole and performance materiality as a percentage of final materiality exceeds certain thresholds (see question 'What percentages do we use to re-assess performance materiality as a percentage of final materiality?').

How do we revise performance materiality? [ISA | 951.11810]

When we revise performance materiality, we follow a similar process to the process we used when determining performance materiality initially. To revise performance materiality, we:

- determine the revised performance materiality amount considering our assessment of the level of aggregation risk (revised for any new information and changes in circumstances); and
- document the considerations made and our rationale for revising performance materiality.

Examples

How do we revise performance materiality in response to a change in aggregation risk? [ISA | 951.1800]

Fact pattern

The engagement team initially established materiality for the financial statements as a whole using estimated amounts. Based on history, they assessed aggregation risk as Normal and established performance materiality at the appropriate percentage of materiality.

During the third quarter, the engagement team re-assessed materiality, considering updated estimates of the metrics, and concluded that materiality remained appropriate.

Analysis

When re-assessing performance materiality, the engagement team considers the following factors that drive our assessment of aggregation risk.

Factor considered	Reassessment result
Effectiveness of the entity's control environment	Based on testing to date, the entity's control environment is effective
Number of internal control deficiencies and level of deficiency	Based on testing to date, we identified an increase in control deficiencies but none stem from a significant deficiency or material weakness
History of misstatements accumulated in audits of the financial statements of prior periods (corrected and uncorrected)	The company had few misstatements in prior periods, but the engagement team has identified that there is an increase in misstatements in the current year.
Level of turnover of senior management or key financial reporting personnel	Key financial reporting personnel have turned over in the current year
Management's preparedness and willingness to correct misstatements	Management is willing to correct any identified misstatements
Proportion of accounts not identified as significant accounts	A small proportion of accounts are identified as not significant

Outcome

After considering these factors, the engagement team determines that aggregation risk is more appropriately assessed at Increased. The engagement team determines that revising performance materiality to 65% of materiality is appropriate. The engagement team then evaluates the effect of lowering performance materiality to the audit.

7 Determine whether to revise lower performance materiality for particular accounts or disclosures [ISA | 7631]

What do we do?

Determine whether to revise lower performance materiality for particular accounts or disclosures

Why do we do this?

Similar to the way we re-evaluate materiality for particular accounts or disclosures, we re-evaluate whether our initial performance materiality for particular accounts or disclosures is appropriate. This allows us to plan and perform appropriate procedures to reduce our audit risk for particular accounts or disclosures to an appropriate level.

Execute the audit

When do we revise performance materiality for a particular account or disclosure? [ISA | 7631.11786]

Whenever we change our assessment of the level of aggregation risk or revise materiality for a particular account or disclosure, a change to performance materiality may be necessary.

As such, in order to determine whether to revise performance materiality for a particular account or disclosure, we:

- re-assess aggregation risk;
- re-assess performance materiality as a percentage of materiality (revised as appropriate) and
- revise performance materiality for a particular account or disclosure as necessary.

Similar to the financial statements as a whole, whether we revise performance materiality for a particular account or disclosure depends on the facts and circumstances of the entity related to that particular account or disclosure.

The only difference for performance materiality for a particular account and the financial statements as a whole is that we consider the facts and circumstances at the particular account or disclosure level and not the financial statements as a whole.

When we revise performance materiality for a particular account or disclosure, we document the revised amount and the factors considered in reaching that conclusion.

Enhanced | What percentages do we use to re-assess performance materiality for a particular account or disclosure? [ISA | 7631.6248]

Based upon our updated assessment of aggregation risk, we determine whether performance materiality for a particular account or disclosure remains appropriate. In doing so, we use the following percentages:

When aggregation risk for the particular account or disclosure is assessed as:	Performance materiality for the particular account or disclosure does not exceed:
Normal	75% of the lower materiality for the particular account or disclosure
Increased	65% of the lower materiality for the particular account or disclosure
High	50% of the lower materiality for the particular account or disclosure

Core and Less Complex | What percentages do we use to re-assess performance materiality for a particular account or disclosure? [ISA | 7631.9004]

Based upon our updated assessment of aggregation risk, we determine whether performance materiality for a particular account or disclosure remains appropriate. In doing so, we use the following percentages:

When aggregation risk for the particular account or disclosure is assessed as:	Performance materiality for the particular account or disclosure does not exceed:
Low	85% of the lower materiality for the particular account or disclosure
Normal	75% of the lower materiality for the particular account or disclosure
Increased	65% of the lower materiality for the particular account or disclosure
High	50% of the lower materiality for the particular account or disclosure

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