STATEMENT OF AUDITING STANDARDS
220
AUDIT MATERIALITY

*(Effective for audits of financial statements for periods beginning before 15 December 2004)**

* HKSA 320 "Audit Materiality" is effective for audits of financial statements for periods beginning on or after 15 December 2004.

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Statements of Auditing Standards (SASs) are to be read in the light of SAS 010 The scope and authority of auditing pronouncements". In particular, they contain basic principles and essential procedures, (auditing standards), indicated by paragraphs in ***bold italic type,*** *with which auditors are required to comply in the conduct of any audit including those of companies applying section 141D of the Companies Ordinance. SASs also include explanatory and other material which is designed to assist auditors in interpreting and applying auditing standards.*

Introduction

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

2. Auditors should consider materiality and its relationship with audit risk when conducting an audit. (SAS 220.1)

3. A matter is material if knowledge of the matter would reasonably influence the economic decisions of users taken on the basis of the financial statements. Materiality may be considered in the context of the financial statements as a whole, any individual statements within the financial statements or individual items included within the financial statements.

4. The economic decisions of users are the judgements and decisions made by a "reasonable" user. It is fair to assume that a "reasonable" user who may rely on financial statements is knowledgeable about them, at least to the extent of understanding their meaning and limitations, including:

   a. financial reporting usually results from approximate measurements that are often based on rules and conventions rather than exact measurements; and

   b. financial statements reflect a combination of known information reported on a historical basis, judgements about current values and estimates of the effects of future events on measurements recorded currently.

5. Materiality depends on the nature and size of the item or error judged in the particular circumstances. Since materiality has both qualitative and quantitative aspects, it is not capable of any general mathematical definition.

Materiality

6. Auditors should plan and perform the audit so as to provide them with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement and give a true and fair view. (SAS 220.2)

7. The assessment of what is material is a matter of professional judgement.

8. In designing the audit plan and the audit programme auditors establish an acceptable materiality level so as to detect quantitatively material misstatements. However both the amount (quantity) and nature (quality) of misstatements are to be considered. Examples of qualitative misstatements include the inadequate or improper description of an accounting policy when it is likely that a user of the financial statements would be misled by the description.

9. Auditors would consider the possibility of misstatements of relatively small amounts that, cumulatively, could have a material effect on the financial statements. For example, an error in a month end procedure could be an indication of a potential material misstatement if that error is repeated each month.

10. Auditors consider materiality at both the overall financial statement level and in relation to individual account balances, classes of transactions and disclosures. Materiality may be influenced by considerations such as legal and regulatory requirements and considerations relating to individual financial statement account balances and relationships. This process may result in different materiality levels depending on the aspect of the financial statements being considered. For example, the degree of accuracy of certain statutory disclosure may make normal materiality considerations inappropriate such as when considering the disclosure of directors' emoluments or loans.

11. Materiality should be considered by auditors when:

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

b. evaluating the effect of misstatements. (SAS 220.3)

The relationship between materiality and audit risk

12. When planning the audit, auditors consider what would make the financial statements materially misstated. The auditors' assessment of materiality, related to specific account balances and classes of transactions, helps them decide such questions as what items to examine and whether to use sampling and analytical procedures. This enables auditors to select audit procedures that, in combination, can be expected to reduce audit risk to an acceptably low level. It also enables auditors to adopt an efficient and effective audit approach.

13. There is an inverse relationship between materiality and the level of audit risk, that is the higher the materiality level, the lower the audit risk and vice versa. Auditors take into account the inverse relationship between materiality and audit risk when determining the nature, timing and extent of audit procedures.

14. The auditors' assessment of materiality and audit risk when evaluating the results of audit procedures may be different from that at the time of initially planning the engagement. This could be because of a change in circumstances or because of a change in the auditors' knowledge as a result of the audit. For example, if the audit is planned prior to the period end, auditors anticipate the results of operations and the financial position. If actual results of operations and financial position are substantially different, the assessment of materiality and audit risk may also change together with the nature, timing and extent of planned audit procedures. Additionally, auditors may, in planning the audit work, intentionally set the acceptable materiality level at a lower level than is intended to be used to evaluate the results of the audit. This may be done to reduce the likelihood of undiscovered misstatements and to provide the auditors with a margin of safety when evaluating the effect of misstatements discovered during the audit.

Evaluating the effect of misstatements

15. In evaluating the fair presentation of the financial statements, auditors should assess whether the aggregate of uncorrected misstatements that have been identified during the audit is material. (SAS 220.4)

16. The aggregate of uncorrected misstatements comprises:

a. specific misstatements identified by the auditors including the net effect of uncorrected misstatements identified during the audit of previous periods; and

b. the auditors' best estimate of other misstatements which cannot be specifically identified (ie. projected errors).

17. Auditors would consider whether the aggregate of uncorrected misstatements is material. If they conclude that the misstatements may be material, auditors would consider reducing audit risk by extending audit procedures or requesting the directors to adjust the financial statements. In any event, the directors may want to adjust the financial statements for the misstatements identified.

18. If the directors refuse to adjust the financial statements and the results of extended audit procedures do not enable the auditors to conclude that the aggregate of uncorrected misstatements is not material, the auditors should consider the implications for their report in accordance with SAS 600 "Auditors' reports on financial statements". (SAS 220.5)

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

Compliance with International Standards on Auditing

20. Compliance with the auditing standards contained in this SAS ensures compliance in all material respects with the basic principles and essential procedures in International Standard on Auditing 320 "Audit Materiality".

Effective date

21. This SAS is effective for audits of financial statements for periods beginning before 15 December 2004.