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Introduction

There is a striking difference in the approach taken in the preparation of public sector specific guidance on accounting and auditing. While the International Public Sector Accounting Standards Board (IPSASB) issues stand-alone public sector accounting standards, the International Organization of Supreme Audit Institutions (INTOSAI) issues practice notes, which provide supplementary guidance for the public sector, in addition to the considerations specific to the public sector contained in the International Standards on Auditing. There is a similarity in that both IPSASB and INTOSAI fly in the jet stream of private sector standard setters. IPSASB only deviates from the International Financial Reporting Standards (IFRS), issued by the IFRS Board, for public sector specific reasons. INTOSAI adds guidance to the International Standards on Auditing, issued by the International Auditing and Assurance Standards Board (IAASB). These public sector specific practice notes are called International Standards of Supreme Audit Institutions (ISSAI).

In this article we illustrate the approach taken in the preparation of public sector specific guidance on auditing by giving an in-depth analysis of ISA 320 *Materiality in Planning and Performing an Audit* and the public-sector specific practice note included in ISSAI 1320 *Materiality in Planning and Performing an Audit.*

The International Auditing and Assurance Standards Board, the IAASB (2008), revised and redrafted the International Standard on Auditing (ISA) about materiality. This ISA is called ISA 320 (Revised and Redrafted) Materiality in Planning and Performing an Audit. ISA 320 is effective for audits of financial statements for periods beginning on or after December 15, 2009.

First, we give a brief summary of the revised standard. We go through a few key requirements and the application material. Subsequently, we focus on the 'considerations specific to public sector entities' contained in the standard. We analyze some of the comments made by various public sector organizations in their comment letters to the exposure drafts of ISA 320. The exposure draft and the comment letters can be downloaded from the IAASB's website (www.iaasb.org). We also analyze how the IAASB in this standard has responded to the arguments that have been put forward in the literature on materiality in government auditing. We conclude with some suggestions for future research.

Prior research in materiality in government auditing

A sizable body of academic research into audit materiality has developed over the years. Iskandar and Iselin (2000) and Messier and others (2005) reviewed and integrated the empirical research in materiality and identified the implications of this research for the audit practice. They also identified many areas for future research. There is, however, little, if any, specific research into materiality in government auditing, although there is a small number of descriptive articles. Price and Wallace (2001, 2002a, 2002b) analyzed the inconsistent usage of the words material, significant, important and substantial in governmental accounting and auditing standards. Some standard setters also use the terms trivial, not clearly insignificant and *de minimis*.

Summary of ISA 320

Background of the revision of ISA 320 is the increased recognition of the need for greater consideration for the nature of an item (and not just its size) and for the circumstances of the entity when determining materiality and evaluating misstatements. The revised ISA 320 provides additional guidance as compared to the existing ISA 320, but is not different in its principles, since the IAASB considers the existing ISA 320 to be conceptually sound. The existing ISA 320 covers two topics: materiality and evaluation of misstatements. The IAASB concluded from comments received that the clarity and flow of the requirements and guidance would be enhanced by addressing materiality and evaluation of misstatements in separate ISAs. The revised ISA 320 deals only with materiality in planning and performing an audit of financial statements. A different ISA, ISA 450 Evaluation of Misstatements Identified during the Audit explains how materiality is applied in evaluating misstatements.

ISA 320 requires the auditor to 1) determine materiality for the financial statements as a whole, 2) determine materiality levels for particular classes of transactions, account balances or disclosures at lower levels than for the financial statements as a whole, and 3) determine a so-called performance materiality which is an amount set by the auditor at less than materiality to reduce to an appropriately low level the probability that the total of uncorrected and undetected misstatements exceeds materiality.

Public sector specific issues in ISA 320

ISA 320 does not contain any public sector specific requirements. All paragraphs relating to the public sector instead are included in the explanatory material. One of the commentators, the Institute of Certified Public Accountants of Kenya, stated in its comment letter that 'given the unique nature of the public sector audit and its impact on the determination of materiality levels, it will be important if such considerations are included as part of the requirements and not as part of the application material as proposed in the exposure draft,' but to no avail.

INTOSAI (2007a, 2007b), the International Organization of Supreme Audit Institutions, issues Practice Notes, which provide supplementary guidance to public sector auditors on ISA 320 and ISA 450, in addition to the considerations specific to public sector entities contained in the ISAs. These public sector specific practice notes are called International Standards of Supreme Audit Institutions, ISSAI 1320 and 1450. Ånerud (2007) explains INTOSAI's approach towards auditing standard setting for the public sector. This approach of issuing practice notes to auditing standards is different from the approach followed by the International Public Sector Accounting Standards Board (IPSASB), since IPSASB issues stand-alone public sector accounting standards.

We now turn to the public-sector specific issues in ISA 320. We will comment, one after the other, on the audit scope, definition of materiality, primary users of financial statements, who determines materiality, how to determine materiality (benchmarks, percentages, qualitative materiality) and the disclosure of materiality.

When the IAASB uses the term public sector, it refers to national governments, regional governments (e.g., state, provincial, territorial), local governments (e.g., cities, towns) and related governmental entities (e.g., agencies, boards, commissions and enterprises). The public sector does not comprise not-for-profit entities which are not part of the government.

Audit scope

The scope of ISA 320 is limited to the audit of financial statements (ISA 320, § 1). ISA 320 therefore does not raise issues relevant to materiality in other audits, such as compliance audit, performance audit or audit of the effectiveness of internal control. The IAASB does not incorporate considerations specific to special purpose audit engagements into the individual ISAs because including material that is not of general application might over-complicate the ISAs. There is a separate ISA, ISA 800, which deals with special purpose audit engagements. ISA 800, however, does not include any public sector specific guidance on materiality either.

ISSAI 1320 (§ P9) adds that if public sector auditors also provide opinions on controls or compliance they separately consider financial statement misstatements, effectiveness of controls and instances of non-compliance when determining materiality levels (INTOSAI, 2007a).

Icerman and Hillison (1989) have argued that the most obvious source of materiality differences between private and public sector audits is the audit scope. The typical scope of audits in the private sector encompasses opinions on financial statements and, to a lesser extent, the adequacy of the internal control structure. Governmental audits may have a wider scope including opinions on whether the entity complied with laws and regulations, whether the entity is managing its resources economically and efficiently, and whether the desired results or benefits are being achieved (performance audits). In addition, public sector entities receiving grants need audits of compliance with rules and regulations and reports on internal controls related to those grants.

Definition of materiality

ISA 320 (§ 2) does not define materiality, but refers the auditor to the applicable financial reporting framework, which usually contains a discussion of materiality for accounting purposes. According to ISA 320 (§ 3), accounting standards provide a frame of reference to the auditor in determining a materiality level for the audit.

ISA 320 states that if the accounting framework does not provide a discussion of materiality, the auditor might use the following definition (which happens to be the materiality definition from IFRS): ‘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.’ So this definition refers to *economic* decisions. ISA 320 adds the following clarification: ‘The financial statements of a public sector entity may be used to make decisions other than economic decisions.’

An economic decision is generally considered to be a choice between alternative uses of scarce resources, with some kind of objective in mind. And indeed, users of financial statements in the public sector do make decisions other than economic decisions. This is clear when we look at the objectives of financial reporting included in the draft conceptual framework issued by IPSASB, which is: ‘Information provided by financial statements is necessary for the discharge of accountability and helps providers of resources and other users make better resource allocation, political and social decisions.’ Those decisions about resource allocation are clearly economic decisions, but the discharge of accountability and political and social decisions arguably are not. The definition of materiality included in

IPSAS 1 Presentation of financial statements does not refer to 'economic decisions', but to 'decisions and assessments'.

ISA 320 (§ A2) states: 'the financial statements may be used to make decisions other than economic decisions.' However, ISA 320 includes this statement in the considerations specific to public sector entities, while financial statements of both public and private sector entities are likely to be used to make economic as well as other than economic decisions. An example of an economic decision in the public sector is a resource allocation decision. Decisions other than economic decisions in the private sector may include a shareholders meeting of a corporation deciding not to discharge the board of directors on the basis of the financial statements. This point is brought forward by the Office of the Controller and Auditor-General of New Zealand in its comment letter. Several other commentators to the exposure draft commented that the content of this paragraph applies equally well to the private and public sector. For example, the Institut der Wirtschaftsprüfer in Deutschland (the German auditors' institute) argued in its response to the exposure draft that this paragraph is not public sector specific and that the standard should be amended accordingly. Likewise, the International Association of Insurance Supervisors recommended in its response to the ISA 320 and 450 exposure drafts that some of the statements made in respect of public sector entities be extended to apply not just to the public sector, but to all entities subject to statutory regulation, such as insurers.

The topic of materiality is on the borderline between accounting and auditing. Practitioners should tie the accounting standards to the auditing standards in order to appropriately determine materiality (Holder and others, 2003). Management usually does not explicitly determine and document a materiality level to be applied in the preparation of the financial statements.

Primary users of financial statements

ISA 320 (§ A2) states: 'In the case of a public sector entity, legislators and regulators are often the primary users of its financial statements.' It is important to identify the primary users since materiality reflects the auditor's judgment of the needs of users in relation to the information in the financial statements and it is not practicable for an auditor to take account of the expectations of all possible individual users of the financial statements.

Governmental accounting and auditing standard setters and commentators to the exposure draft disagree on the primary users of governmental financial statements. Some standard setters regard the citizenry rather than the legislature as the primary users. The United States Governmental Accounting Standards Board (GASB, 1987) states that financial statements are prepared for those to whom government is primarily accountable (the citizenry), for those who directly represent the citizens (legislative and oversight bodies), and for those who lend or participate in the lending process (investors and creditors). In its comment letter to the exposure draft, the UK Audit Commission raises the issue of the primary users of government financial statements, stating that the definition in terms of 'legislators and regulators' is very narrow. The Audit Commission considers that the standard would benefit from the addition of 'funders and financial supporters' as primary users of financial statements. INTOSAI states in its comment letter: 'For public sector entities, legislators are the providers of funding for various government programs, activities, and functions and regulators frequently evaluate or make decisions about an entity's activities. Financial statements that meet the needs of legislators and regulators will also meet most of the needs of other users. These other users may include bondholders, the media, or citizens. In situations where public funds are used, the financial statements may also represent a key element of a governmental entity's accountability to the public. However the auditor's target user group is generally the group of legislators and regulators who are in the position of providing funding for and making decisions about the governmental entity under audit.' ISSAI 1320 further elaborates on the users of governmental financial statements.

The Australasian Council of Auditors-General suggests the *pars pro toto* approach to be applied to both public and private sector. The Council suggested the following wording in its comment letter: 'For a profit oriented entity, investors are considered to be the primary users of financial statements. Their needs will also meet most of the needs of other users that financial statements can satisfy. In the public sector, Parliament is considered to be the primary user of financial statements. Parliament's needs will also meet most of the needs of other users such as the general public and rating agencies.' This wording would imply that, if the auditor determines a materiality level that legislators agrees with, the needs of other users are likely to be met as well.

Who determines materiality

ISA 320 (§ 10) states: 'the auditor shall determine materiality'

ISSAI 1320 (§ P6) adds: 'When determining materiality levels for controls and non-compliance, public sector auditors take into account the legislators' and regulators' expectations as regards cost-effectiveness of controls and non-compliance.'

Some regulators in public sector auditing keep it nevertheless to themselves to determine materiality, prescribing in detail benchmarks and percentages that auditors should apply in government auditing. For instance, the Dutch Minister of the Interior and Kingdom Relations issued a ministerial decree mandating auditors of municipalities and provinces (audit firms, usually Big 4) to apply a materiality level of 1% of total expenses for the evaluation of misstatements and 3% of total expenses for significant uncertainties. An uncertainty is a matter whose outcome depends on future actions or events not under the direct control of the entity but that may affect the financial statements.

Similarly, the Dutch State-Secretary of Transport, Public Works and Water Management established materiality levels for the audits of financial statements of waterboards. Also, the Minister of Finance, after consultation with the Netherlands Court of Audit, Parliament and fellow Ministers, decided upon detailed benchmarks and percentages for the audit of financial statements of central government and included them in the handbook for central government auditing. The same percentages apply to the audit of compliance with rules and regulations.

These materiality levels are presented in Table 1. Example: if errors found in the financial statements do not exceed 1% of total expenditures, the auditor issues an unqualified audit opinion.

Table 1. Nature of audit opinion

	Unqualified opinion	Qualified opinion	Disclaimer of opinion	Adverse opinion
Errors in the financial statements (percentage of total expenditures)	≤ 1%	> 1% < 3%	-	≥ 3%
Uncertainties in the audit (percentage of total expenditures)	≤ 3%	> 3% < 10%	≥ 10%	-

Source: Handbook for Central Government Auditing, Ministry of Finance, the Netherlands

Determining materiality

Benchmarks

ISA 320 (§§ A3-A7) deals extensively with the appropriate benchmark as a starting point in determining materiality. Factors that may affect the identification of an appropriate benchmark (such as relative volatility) are listed and various examples are suggested for application. These examples include profit before tax, total revenue, gross profit and total expenses, total equity and net asset value. While these benchmarks are mainly private sector oriented, there is a separate paragraph (§ A9) entitled 'Considerations specific to public sector entities', which states: '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.' Net cost (an accrual accounting term) is explained between brackets as 'expenses less revenues' (an accrual accounting term) and 'expenditure less receipts' (a cash accounting term). In cash accounting environments total expenditures are often used as a benchmark. Expenditure less receipts is commonly referred to as deficit, if expenditures are greater than receipts. In practice the deficit and its opposite, the surplus, are rarely used as benchmarks for the determination of materiality in government auditing, probably because of their relative volatility.

ISSAI 1320 (P11) adds: "For public sector entities that are expected to recover costs or break-even, net costs may not be an appropriate benchmark. In those cases gross expenditure or gross revenues may be a more relevant benchmark."

It is unclear why ISA 320 (§ A9) refers to program activities rather than the wider term government financial statements. Both the words expenses and cost are used in this paragraph, even though they are generally considered to be synonymous.

The paragraph entitled 'Considerations specific to public sector entities' (§ A9) finally states: 'Where a public sector entity has custody of public assets, assets may be an appropriate benchmark.' Custody is a particularly evasive term in this respect, because, depending on the financial reporting framework applied, custody of assets does not necessarily imply recognition of the assets on the entity's statement of financial position. Many accounting standards require recognition of assets if the entity has control over the assets and if future economic benefits or service potential is expected to flow to the entity. With assets in custody this is not always the case. Public assets in custody per se are therefore unlikely to be an appropriate benchmark for the determination of materiality.

Percentages

ISA 320 contains some illustrative examples of percentages to determine materiality, although not in the considerations specific to public sector entities: '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.' (paragraph A7). Some authors have argued that a guideline can be a starting point, even though it cannot substitute for professional judgment. Raman and Van Daniker (1994) propose a sliding-scale materiality guideline that auditors can use for the evaluation of their professional judgments. INTOSAI in its comment letter opposes illustrative examples of percentages in the standard, as it is concerned that such examples increase the likelihood that these percentages will become the default percentages used by auditors. For this reason, INTOSAI believed that the specific percentages should be removed from the proposed ISA, and instead that the standard should discuss only appropriate potential benchmarks. Auditors may have good reasons for selecting percentages that differ from those shown in the standard, but could have their judgment questioned simply because it is different from the percentages shown in the standard. INTOSAI was not the only commentator to oppose illustrative examples of percentages in the standard. The United States Government Accountability Office in its comment letter endorses INTOSAI's comment letter. Not only public sector organizations opposed percentages in the standard. The Institute of Chartered Accountants of Scotland states: 'the specific percentage given … is likely to increase the level of substantive testing undertaken for the audit of some public sector entities. We do not believe this will lead to a demonstrable improvement in audit quality.' ACCA, the UK-based Association of Chartered Certified Accountants, argues that the impact of percentages in a standard is so great that the use of caveats (through the use of wording such as 'Illustrative examples…that might be considered include …') is insufficient to mitigate the threat that they will become rules, and that auditors will be called on to justify their use of higher levels.

Qualitative Materiality

ISA 320 does not use the words quantitative and qualitative, but refers to size and nature of misstatements instead. Even though many respondents to the exposure draft identified the need for more prominent guidance on the qualitative aspects of materiality, the standard merely explains that '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' (§ 2) and 'The circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are below the materiality' (§ 6).

ISA 450 (§ A16) provides guidance on qualitative materiality by listing misstatements that the auditor may evaluate as material, even though they are lower than materiality for the financial statements as a whole. In the basis for conclusions the IAASB points out that there are qualitative aspects that affect the auditor's professional judgment in determining materiality and tolerable error for planning and performing the audit, and in evaluating the effect of uncorrected misstatements on the financial statements and related auditor's report.

The auditor is therefore alert for such misstatements when performing the audit. However, according to the IAASB, it is not practicable to design audit procedures to detect misstatements that could be material solely because of their nature.

Qualitative materiality refers to the nature of a transaction or amount and includes many financial and nonfinancial items that, independent of the amount, may influence the decisions of a user of the financial statements. Some authors have emphasized that in government, the political sensitivity to adverse media exposure often concerns the nature rather than the size of an amount, such as illegal acts, bribery, corruption and related party transactions. An example is the remuneration of high government officials, such as ministers and top-management of some semi-autonomous agencies, and their travel and hospitality expenses. These pay packages may not be quantitatively material to the financial statements as a whole, but they are politically sensitive. Qualitative materiality considerations therefore should not be ignored – they can and frequently do influence the nature and scope of governmental audits (Ramamoorti and Hoey, 1998).

Disclosure of materiality

ISA 320 neither mandates nor forbids the disclosure of engagement specific materiality considerations for public scrutiny. Although ISA 320 does not require the auditor to communicate materiality, ISA 450 (§ 8) requires the auditor to communicate to management misstatements identified during the audit, other than those that are clearly trivial.

Auditors usually hold the engagement-specific materiality level *sub rosa*. Some authors favor the disclosure of the materiality level, chosen by the auditor for a specific engagement. This might be particularly relevant for audits of governments, because of the importance of transparency. Roberts and Dwyer (1998) have argued that current practice and disclosure regarding audit materiality is paternalistic. That is, the auditor determines materiality on behalf of the user, and does not disclose the determination, while the profession has adopted technical standards that are not explicit enough for users to infer the likely levels of materiality employed on specific engagements. This significantly reduces users' decision making autonomy. Roberts and Dwyer state that auditors should disclose the chosen materiality level, because research revealed that groups of auditors evaluating the same audit situations reach different conclusions about materiality levels. Furthermore, the evidence suggests that auditors' judgments regarding materiality are often not in agreement with those of other classes of reasonable persons.

Disagreement arose for example about the $51 million adjustment that Arthur Andersen waived on the audit of Enron's financial statements. According to Andersen this amount was not material, using annual reported earnings as a benchmark (Berardino, 2001). Although several commentators questioned this materiality judgment, much of the professional materiality guidance supports Andersen's decision to consider the adjustment immaterial (Brody and others, 2003).

It is unclear why ISA 320 is silent on the disclosure of materiality. A disclosure about this complex topic would involve much more than a single amount for the financial statements as a whole, since there might be different materiality levels for particular classes of transactions, account balances or disclosures. For the audit of group financial statements the materiality may differ between components of the group. Also, the impact of materiality on the audit program might be unclear to many users of the financial statements. The auditor would have a lot to explain.

Summary of public sector specific comments

Table 2. Summary of public sector specific comments

(ref. sections 4.1-4.6)

		ISA 320	Public sector specific comment
1. Audit scope		Audit of financial statements	More guidance may be needed because of wider audit scope in public sector, e.g., compliance audit, performance audit
2. Definition of materiality		Economic decisions	ISA 320 acknowledges that financial statements in the public sector are also used for other than economic decisions
3. Primary users of financial statements		Investors	ISA 320 identifies legislators and regulators in the public sector
4. Who determines materiality		Auditor	Regulators rather than auditors determine materiality (in some countries)
5. Determining materiality:	**Benchmarks**	Provides examples, e.g., profit before tax, total revenue, total equity, net asset value	ISA 320 provides additional examples: total cost or net cost (expenses less revenues or expenditure less receipts) for program activities
	Percentages	Provides illustrative examples	Public sector commentators oppose providing examples
	Qualitative materiality	ISA 450 provides guidance	More guidance may be needed because of political sensitivity
6. Disclosure of materiality		Neither mandates, nor forbids	More guidance may be needed because of importance of transparency

From the analysis presented in sections 4.1 through 4.6, summarized in Table 2, we can conclude that ISA 320 does not contain any public-sector specific deviation from materiality guidelines applicable to all audits. This is in spite of the arguments put forward by some authors who think that materiality in government auditing should be different. Carmichael and Holder (1987) refer to the 'unique considerations that are necessary in making materiality judgments in a government audit.' The need for public sector specific materiality requirements has been recommended by Raman and Van Daniker (1994). The reasoning is as follows. Public sector entities typically pose a low risk of client financial failure and subsequent discovery of misstatements in financial statements. This relatively stable environment leads to competitive audit pricing practices and an undue emphasis on price in auditor selection by public sector entities. Consequently, the need for materiality guidelines (as a possible standard for an audit's sufficiency) may be greater in government than in a corporate context. INTOSAI, in its comment letter to the ISA 320 exposure draft (IAASB, 2004), states that difference in materiality may be required: 'For governmental entities, auditors may need to set materiality levels based on various legal and regulatory requirements or on the visibility and sensitivity of government programs. Government auditors also may have additional responsibilities for detecting fraud, waste, or abuse that might require different materiality thresholds.'

However, since the ISAs are principles-based, it is reasonable to expect little, if any, deviations from the principles. By focusing on the particular facts and circumstances of entities in the public sector, the standards would quickly become rules-based. Although the practical application of materiality guidelines may differ between private and public sector audits, the principles should and do remain the same. The discussion whether a standard on materiality in auditing should include public sector specific requirements and explanatory material is, in essence, a debate about principles-based vs. rules-based standard setting. The standards issued by the IAASB are principles-based. Although the IAASB handbook of pronouncements has become quite voluminous over the years, the board refrains from issuing detailed rules for specific situations. Some accountants favor the rules-based approach because they argue that rules are needed in order to achieve consistency. Otherwise, different auditors will apply different materiality levels to similar entities. Others think that rules-based standards would quickly become too complex and would not be transparent for users of financial statements. They support a principles-based approach, which provides limited guidance and requires greater use of professional judgment. The principles-based approach is also applied in the IFRS and IPSAS accounting standards. From the above analysis of ISA 320 and the IAASB's reaction to the commentators' responses to the exposure draft, we can conclude that the proponents of the principles-based approach have prevailed.

Future research in materiality in government auditing

Based on the above analysis of ISA 320 it is clear that there are many research opportunities in materiality in government auditing; we will highlight some high potential areas. A review of national government auditing standards and practices might provide comparative information on the variability of the approaches to materiality between countries, including benchmarks and percentages or sliding scales used. It is also important to know to what degree governmental auditors set lower materiality levels for particular classes of transactions, account balances or disclosures than for the financial statements as a whole. Future research might also examine whether auditors and the users of government financial statements (legislators, regulators, citizenry) hold the same view regarding the required level of materiality, taking into account political sensitivity. Last, future research could investigate materiality in audits of compliance with laws and regulations, operational audits and performance audits. There are many research opportunities – and needs for research – when it comes to materiality in government auditing. Standard setting should be based on solid research.

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