

ISSAI 1320

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Financial Audit Guideline

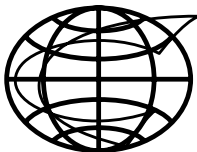
Materiality in Planning and Performing an Audit

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This Financial Audit Guideline draws on International Standard on Auditing (ISA) 320 “Materiality in Planning and Performing an Audit” developed by the International Auditing and Assurance Standards Board (IAASB) and published by the International Federation of Accountants (IFAC). The ISA is included in this Guideline with the permission of IFAC.

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Practice Note¹ to International Standard on Auditing (ISA) 320

Materiality in Planning and Performing an Audit

Background

This Practice Note provides supplementary guidance to public sector auditors on ISA 320 – Materiality in Planning and Performing an Audit. It is read together with the ISA. ISA 320 is effective for audits of financial statements for periods beginning on or after December 15, 2009. The Practice Note is effective the same date as the ISA.

Introduction to the ISA

ISA 320 deals with the auditor’s responsibility to apply the concept of materiality in planning and performing an audit of financial statements. ISA 450² 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.

Content of the Practice Note

- P1. The Practice Note provides additional guidance for public sector auditors related to:
- (a) Overall Considerations.
 - (b) Materiality in the Context of an Audit.
 - (c) Determining Materiality and Performance materiality when Planning the Audit.
 - (d) Revision as the Audit Progresses.

Applicability of the ISA in Public Sector Auditing

- P2. ISA 320 is applicable to auditors of public sector entities in their role as auditors of financial statements.

Additional Guidance on Public Sector Issues

- P3. ISA 320 contains application and other explanatory material with considerations specific to public sector entities in paragraphs A2 and A9 of the ISA.

¹ All Practice Notes are considered together with ISSAI 1000 “General Introduction to the INTOSAI Financial Audit Guidelines.”

² ISA 450, “Evaluation of Misstatements Identified during the Audit.”

Overall Considerations

- P4. The objectives of a financial audit in the public sector are often broader than the scope of the ISAs, which involves reporting whether the financial statements have been prepared, in all material respects, in accordance with the applicable financial reporting framework (i.e. the scope of the ISAs). The audit mandate may also result in additional objectives considered related to the audit of financial statements. These objectives may include additional audit and reporting responsibilities, for example, relating to reporting whether the auditor found any instances of non-compliance with authorities including budget and accountability and/or reporting on the effectiveness of internal control. Even in cases where there are no such additional reporting objectives, there may be general public expectations in regard to public sector auditors' reporting of non-compliance with authorities or reporting on the effectiveness of internal control. Therefore, public sector auditors keep such expectations in mind when determining materiality. Additional responsibilities related to compliance with authorities, are dealt with in the INTOSAI Compliance Audit Guidelines (ISSAI 4000³ and 4200⁴). Public sector auditors with such additional responsibilities may consider ISSAIs 4000 and 4200.

Materiality in the Context of an Audit

- P5. When determining materiality for planning purposes in the public sector both quantitative and qualitative matters as well as the nature of items are of importance. The context in which the matter appears may be of importance. Furthermore, the inherent nature or characteristics of items, or groups of items, may render them material.
- P6. Paragraph A2 of ISA 320 states that the legislators and regulators are often the primary users of the public sector entities' financial statements, and that the financial statements may be used to make decisions other than economic ones. Legislators represent the citizens and provide funding for various government programs, activities, and functions. Legislators and/or regulators frequently evaluate or make decisions about an entity's activities. Other users may include entity management, bondholders or the media. Financial statements that meet the needs of legislators and regulators will also meet most of the needs of other users.
- P7. The financial statements may also represent a key element of a public sector entity's accountability to the public. The accountability framework may introduce other factors that influence the determination of materiality at different levels. As a consequence, materiality is likely to be a result of both quantitative and qualitative factors, and materiality levels for particular classes of transactions, account balances and disclosures may therefore often be set at a low level.

³ ISSAI 4000, "General Introduction to Guidelines on Compliance Audit."

⁴ ISSAI 4200, "Compliance Audit Guidelines Related to Audit of Financial Statements."

Determining Materiality and Performance Materiality When Planning the Audit

- P8. As noted above, materiality in the public sector includes both quantitative and qualitative aspects (referred to in the ISAs as aspects related to the “size” and “nature” of misstatements). The determination of a materiality level or levels is described in paragraphs 10 and 11 of the ISA. In the public sector, materiality levels for classes of transactions, account balances or disclosures may be set at a lower level than the materiality levels that would be derived by following the requirements of the ISA. This may be for a variety of reasons, including the context of the matter, or the nature and characteristics of the systems and entities involved as explained in paragraphs P5 – P7 above. Furthermore, certain procedures may be required to be performed by audit mandate or legislation. Examples of such procedures might be tests of ministerial salaries regulated by statute and sensitive payments such as travel and hospitality of senior staff. In the rare cases where the public sector auditors want to detect all such misstatements, they test all relevant transactions.
- P9. Where public sector auditors also provide opinions on the effectiveness of controls or compliance with laws and regulations they consider the need to establish materiality for these objectives in addition to materiality for the financial statements. For example, when reporting on the effectiveness of controls, the auditor may use a benchmark based on the percentage of transactions or monetary amounts sampled to determine materiality for evaluating control deviations.
- P10. Paragraph A2 of the ISA describes considerations specific to determining materiality levels in the public sector. When determining whether a particular class of transactions, account balance, disclosure, or other assertion which is part of the financial reporting framework, is material by virtue of its nature, public sector auditors take into account qualitative aspects such as:
- The context in which the matter appears, for example if the matter is also subject to compliance with authorities, legislation or regulations, or if law or regulation prohibits overspending of public funds, regardless of the amounts involved;
 - The needs of the various stakeholders and how they use the financial statements;
 - The nature of the transactions that are considered sensitive to users of the financial statements;
 - Public expectations and public interest, including emphasis placed on the particular matter by relevant committees in the legislature, such as a public accounts committee, including the necessity of certain disclosures;
 - The need for legislative oversight and regulation in a particular area; and
 - The need for openness and transparency, for example if there are particular disclosure requirements for frauds or other losses.
- P11. Paragraph A9 of the ISA discusses identifying appropriate benchmarks for financial statement materiality. 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. For public sector entities that are custodians of large amounts of assets, total assets, total liabilities, net assets or net liabilities or certain classes of assets might be an appropriate benchmark if they are accounted for in the financial statements. In some cases, especially when considering qualitative materiality, other types of benchmarks may also be useful. For example:
- The number of users or entities affected as a percentage of total users or entities involved in the particular program;

- Those amounts previously considered material by a relevant committee in the legislature, such as public accounts committee; and
- Benefit payments as compared to cost of living indicators, for example the importance to the eligible recipient of monthly benefit payments, such as retirement or disability, paid out in accordance with public sector programs.

Revision as the Audit Progresses

- P12. Paragraphs 12, 13 and A13 of the ISA discuss the need to revise materiality levels in the event of becoming aware of new information during the course of the audit. Due to governance structures and interrelationships of entities within the public sector, it is not unusual for public sector auditors to receive new information during the course of the audit.

International Standard on Auditing

Materiality in Planning and Performing an Audit



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INTERNATIONAL STANDARD ON AUDITING 320 MATERIALITY IN PLANNING AND PERFORMING AN AUDIT

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

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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

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 450¹ 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.

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.
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

¹ ISA 450, "Evaluation of Misstatements Identified during the Audit."

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.

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 the size of 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. Although it is not practicable to design audit procedures to detect misstatements that could be material solely because of their nature, the auditor considers not only the size but also the nature of uncorrected misstatements, and the particular circumstances of their occurrence, when evaluating their effect on the financial statements.³

³ ISA 450, paragraph A16.

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, performance materiality means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.

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. A2-A11)
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. A12)

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. A13)
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.

Documentation

14. The auditor shall include in the audit documentation the following amounts and the factors considered in their determination:⁴
- (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).

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.⁵ The auditor obtains reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level.⁶ Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk.⁷ Materiality and audit risk are considered throughout the audit, in particular, when:

⁴ ISA 230, "Audit Documentation," paragraphs 8-11, and paragraph A6.

⁵ ISA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing," paragraph 11.

⁶ ISA 200, paragraph 17.

⁷ ISA 200, paragraph 13(c).

- (a) Identifying and assessing the risks of material misstatement;⁸
- (b) Determining the nature, timing and extent of further audit procedures;⁹
and
- (c) Evaluating the effect of uncorrected misstatements, if any, on the financial statements¹⁰ and in forming the opinion in the auditor's report.¹¹

Determining Materiality and Performance Materiality When Planning the Audit

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

A2. 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)

A3. 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);

⁸ ISA 315, "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment."

⁹ ISA 330, "The Auditor's Responses to Assessed Risks."

¹⁰ ISA 450.

¹¹ ISA 700, "Forming an Opinion and Reporting on Financial Statements."

- 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.
- A4. 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.
- A5. 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.
- A6. 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.
- A7. 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

- A8. 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

- A9. 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)

- A10. 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, and the remuneration of management and those charged with governance).
 - 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, a newly acquired business).
- A11. 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.

Performance Materiality (Ref: Para. 11)

- A12. 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 to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole. Similarly, performance materiality relating to a materiality level determined for a particular class of transactions, account balance or disclosure is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in that particular class of transactions, account balance or disclosure exceeds the materiality level for that particular class of transactions, account balance or disclosure. The determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by the auditor's understanding of the entity, updated during the performance of the risk assessment procedures; and the nature and extent of misstatements identified in previous audits and thereby the auditor's expectations in relation to misstatements in the current period.

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

- A13. 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.

