

*Proposed Redrafted International Standards on
Auditing*

ISA 320 (Revised), Materiality in
Planning and Performing an Audit

ISA 450, Evaluation of Misstatements
Identified during the Audit



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REQUEST FOR COMMENTS

The International Auditing and Assurance Standards Board (IAASB), an independent standard-setting body within the International Federation of Accountants (IFAC), approved the exposure drafts, proposed International Standard on Auditing (ISA) 320 (Revised and Redrafted), “Materiality in Planning and Performing and Audit” and proposed ISA 450 (Redrafted), “Evaluation of Misstatements Identified during the Audit,” for publication in October 2006. The proposed ISAs may be modified in light of comments received before being issued in final form.

Please submit your comments, preferably by e-mail, so that they will be received by **February 15, 2007**. All comments will be considered a matter of public record. Comments should be addressed to:

Executive Director, Professional Standards
International Auditing and Assurance Standards Board
International Federation of Accountants
545 Fifth Avenue, 14th Floor
New York, New York 10017 USA

Email responses should be sent to: Edcomments@ifac.org

Copies of the exposure drafts may be downloaded free-of-charge from the IFAC website at <http://www.ifac.org>.

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EXPLANATORY MEMORANDUM

Introduction

This memorandum provides background to proposed International Standards on Auditing (ISA) 320 (Revised and Redrafted), “Materiality in Planning and Performing an Audit” and ISA 450 (Redrafted), “Evaluation of Misstatements Identified during the Audit.” The proposed ISAs have been redrafted in accordance with conventions agreed by the International Auditing and Assurance Standards Board (IAASB) to be applied to all ISAs. The IAASB approved the proposed redrafted ISAs for exposure in October 2006.

Background

In December 2004, the IAASB issued an exposure draft of proposed ISA 320 (Revised), “Materiality in the Identification and Evaluation of Misstatements.” The comment period closed on April 30, 2005.

The IAASB gave due consideration to the comments received on the proposed ISA and also consulted further with the IAASB Consultative Advisory Group. The IAASB concluded that the clarity and flow of the requirements and guidance would be enhanced by addressing materiality and misstatements in separate ISAs; that is, an ISA on materiality in planning and performing an audit and an ISA on evaluating misstatements identified during the audit. This, and the basis for the IAASB’s other conclusions, are explained in the *Basis for Conclusions: ISA 320 (Revised), Materiality in Planning and Performing an Audit and ISA 450, Evaluation of Misstatements Identified during the Audit*.

The IAASB approved “close off” documents of ISA 320 (Revised) and ISA 450 in the “old style” (i.e., following the IAASB’s current drafting conventions) in May 2006. Those documents incorporate the changes based on the comments received on the December 2004 exposure draft. They formed the basis for the proposed redrafted ISAs.

The Basis for Conclusions and “close off” documents are available on the IAASB website at <http://www.ifac.org/Guidance/EXD-Details.php?EDID=0062>. They are referenced here for information purposes only and do not form part of the exposure drafts.

The conventions used by the IAASB in redrafting these ISAs for exposure, and the authority and obligation attaching to those conventions, are established in the amended Preface to International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services (Preface), approved by the IAASB in September 2006. Some respondents may wish to consider the proposed redrafted ISAs in light of the authority and obligation attaching to the conventions, as established in the amended Preface. Accordingly, for this purpose the IAASB has made available to respondents the amended Preface on the IAASB website at http://www.ifac.org/IAASB/downloads/Preface_Amended_September_2006.pdf.¹

¹ Before the IAASB issues an international pronouncement in final form, the Public Interest Oversight Board (PIOB) performs a review to satisfy itself whether the IAASB has complied fully with its due process. The IAASB concluded that the PIOB should be advised of the amendments to the Preface at the same time as it is given the first four ISAs redrafted in accordance with the amended Preface (i.e., ISAs 240, 300, 315 and 330). The last of these ISAs was approved in October 2006 and, at the date of issuing this exposure draft, the PIOB has not yet completed

Effective Date

The proposed redrafted ISAs will not become effective at a date earlier than December 15, 2008.

Guide for Respondents

The IAASB has carefully considered the comments on the December 2004 exposure draft and is not seeking, and will not consider, comments on matters that have been debated and resolved in arriving at the “close off” documents.

The IAASB is seeking comments **only** on changes resulting from applying the clarity drafting conventions and their effect on the content of the ISAs. Respondents are asked to respond in particular to the following questions:

1. Is the objective to be achieved by the auditor, stated in each of the proposed redrafted ISAs, appropriate?
2. Have the criteria identified by the IAASB for determining whether a requirement should be specified been applied appropriately and consistently, such that the resulting requirements promote consistency in performance and the use of professional judgment by auditors?²

Comments are most helpful when they refer to specific paragraphs, include the reasons for the comments, and, where appropriate, make specific suggestions for any proposed changes to wording. When a respondent agrees with proposals in the exposure drafts, it will be helpful for the IAASB to be made aware of this view.

Supplements to the Exposure Drafts

To assist respondents in tracking changes, IAASB staff has prepared for each of the proposed redrafted ISAs an analysis of the decisions that have been made by the IAASB with respect to the treatment of the present tense in the explanatory paragraphs of the “close off” documents. These analyses demonstrate how the material in the “close off” documents has been reflected in the proposed redrafted ISAs. In particular, the analysis:

- Identifies existing sentences in the present tense and whether they are now treated as a requirement or as application material;

its review of due process for the Preface and the four ISAs. Only when this is completed can a document be considered “final.” The Preface and the four ISAs therefore will be issued in final form only when the PIOB is satisfied that the stated due process has been fully complied with.

² The IAASB has identified the following criteria for determining the requirements of a Standard:

- The requirement is necessary to achieve the objective stated in the Standard;
- The requirement is expected to be applicable in virtually all engagements to which the Standard is relevant; and
- The objective stated in the Standard is unlikely to have been met by the requirements of other Standards.
- In determining the requirements of a Standard, the IAASB will consider whether the requirements are proportionate to the importance of the subject matter of the Standard in relation to the overall objective of the engagement.

The criteria, which are intended only to assist the IAASB in appropriately and consistently determining requirements, may be refined as further experience is gained.

EXPLANATORY MEMORANDUM

- Maps the material of each close off document to the proposed redrafted ISA; and
- Identifies explanatory material that is proposed to be eliminated or repositioned as a result of redrafting.

These Staff-prepared mapping documents are available on the IAASB website at <http://www.ifac.org/Guidance/EXD-Details.php?EDID=0062>. They are for information purposes only and do not form part of the exposure drafts.

**PROPOSED INTERNATIONAL STANDARD ON AUDITING 320
(REVISED AND REDRAFTED)**

MATERIALITY IN PLANNING AND PERFORMING AN AUDIT

(Effective for audits of financial statements for periods beginning on or after [date])*

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International Standard on Auditing (ISA) 320 (Revised and Redrafted), “Materiality in Planning and Performing an Audit” should be read in the context of the “Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services,” which sets out the authority of ISAs.

* See footnote 4.

Introduction

Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the determination of materiality and its application in planning and performing an audit of financial statements. ISA 450, “Evaluation of Misstatements Identified during the Audit” deals with how materiality is applied in evaluating misstatements identified during the audit of 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 the 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.³ The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered. (Ref: Para. A1)
3. Such a discussion, if present in the applicable financial reporting framework, provides a frame of reference to the auditor in determining a materiality level or levels for the audit. If the applicable financial reporting framework does not include a discussion of materiality, the characteristics referred to in paragraph 2 provide the auditor with such a frame of reference.
4. The auditor’s determination of a materiality level or levels 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 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

³ For example, the International Accounting Standards Board’s “Framework for the Preparation and Presentation of Financial Statements” 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.

- (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 financial statements and the opinion in the auditor's report.
- 6. In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. These judgments affect the nature, timing and extent of audit procedures. The materiality level or levels determined when planning the audit do not necessarily establish a threshold below which misstatements identified during the audit 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 the materiality level or levels. It is not practicable to design audit procedures to detect misstatements that could be material solely because of their nature; however, the auditor considers not only the size but also the nature of any identified misstatements, and the particular circumstances of their occurrence, when evaluating their effect on the financial statements and the opinion in the auditor's report (see ISA 450).

Effective Date

- 7. This ISA is effective for audits of financial statements for periods beginning on or after [date].⁴

Objective

- 8. The objective of the auditor is to determine, and reconsider as the audit progresses, an appropriate materiality level or levels to enable the auditor to plan and perform the audit. (Ref: Para. A2)

Requirements

Determining Materiality when Planning the Audit

Materiality Level for the Financial Statements as a Whole

- 9. When establishing the overall audit strategy, the auditor shall determine a materiality level for the financial statements as a whole for purposes of:
 - (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. (Ref: Para. A3-A10)

Materiality Levels for Particular Classes of Transactions, Account Balances or Disclosures

- 10. When establishing the overall strategy for the audit, the auditor shall also consider whether, in the specific circumstances of the entity, there are particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than the materiality level 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. In such circumstances, the

⁴ This date will not be earlier than December 15, 2008.

auditor shall determine the materiality levels to be applied to those particular classes of transactions, account balances or disclosures. (Ref: Para. A11-A12)

Amounts Lower than the Materiality Level or Levels for Purposes of Assessing Risks and Designing Further Audit Procedures

11. The auditor shall determine an amount or amounts lower than the materiality level for the financial statements as a whole (and an amount or amounts lower than the materiality level for particular classes of transactions, account balances or disclosures, if applicable) for purposes of assessing the risks of material misstatement and designing further audit procedures to respond to assessed risks. (Ref: Para. A13)

Considerations as the Audit Progresses

12. The auditor shall revise the materiality level for the financial statements as a whole (and the materiality level for a particular class of transactions, account balance or disclosure, if applicable) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different materiality level or levels initially. (Ref: Para. A14)
13. If the auditor concludes that lower materiality level or levels than that initially determined are appropriate, the auditor shall reconsider the lower amount or amounts determined for purposes of assessing risks of material misstatement and designing further audit procedures, and the appropriateness of the nature, timing and extent of further audit procedures.

Documentation

14. The auditor shall document the following amounts and the factors considered in their determination:
 - (a) The materiality level for the financial statements as a whole (see paragraph 9);
 - (b) The materiality level for a particular class of transactions, account balance or disclosure, if applicable (see paragraph 10);
 - (c) The amount or amounts determined for purposes of assessing risks of material misstatement and designing further audit procedures (see paragraph 11); and
 - (d) Any changes made to (a)-(c) as the audit progressed (see paragraphs 12-13).

* * *

Application and Other Explanatory Material

Materiality in the Context of an Audit (Ref: Para. 2)

Considerations Specific to Public Sector Entities

- A1. 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.

Materiality and Audit Risk (Ref: Para. 8)

A2. ISA 200, “Objective and General Principles Governing an Audit of Financial Statements,” requires the auditor to plan and perform the audit to reduce audit risk to an acceptably low level that is consistent with the objective of an audit. 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 risk of material misstatement of the financial statements and the risk that the auditor will not detect such misstatement. Materiality and audit risk are considered throughout the audit, in particular, when:

- (a) Identifying and assessing the risks of material misstatement (see ISA 315 (Redrafted), “Identifying and Assessing the Risk of Material Misstatements Through Understanding the Entity and Its Environment”);
- (b) Determining the nature, timing and extent of further audit procedures (see ISA 330 (Redrafted), “The Auditor’s Responses to Assessed Risks”); and
- (c) Evaluating the effect of uncorrected misstatements on the financial statements and the opinion in the auditor’s report (see ISA 450).

Determining Materiality when Planning the Audit

Considerations Specific to Public Sector Entities

A3. The determination of materiality level or levels in an audit of the financial statements of a public sector entity is influenced by legislative and regulatory requirements, and by the financial information needs of legislators and the public in relation to public sector programs.

Materiality Level for the Financial Statements as a Whole

Use of Benchmarks in Determining Materiality (Ref: Para. 9)

A4. Determining a materiality level for the financial statements as a whole requires the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in that determination. Factors that may affect the identification of an appropriate benchmark include the following:

- The elements of the financial statements (e.g., assets, liabilities, equity, income, expenses);
- Whether there are items on which the attention of the users of the particular entity’s financial statements tends to be focused (e.g., 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 at 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 (e.g., 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. When an appropriate benchmark has been identified, relevant financial data to be used in determining the materiality level for the financial statements as a whole is identified. 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 (e.g., 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, the materiality level 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 the materiality level is more appropriately determined using a normalized profit before tax from continuing operations figure based on past results.
- A7. The materiality level is determined in relation 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, the materiality level is determined in relation to the financial statements prepared for that financial reporting period.
- A8. Determining a percentage to be applied to a chosen benchmark requires 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 Levels for Particular Classes of Transactions, Account Balances or Disclosures
(Ref: Para. 10)

A11. Factors that may affect the auditor’s consideration of whether to determine materiality levels to be applied to particular classes of transactions, account balances or disclosures include the following:

- Whether law, regulations or the applicable financial reporting framework affect users’ expectations regarding the measurement or disclosure of certain items (e.g., 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 (e.g., 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 (e.g., a newly acquired business).

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.

Amounts Lower than the Materiality Level or Levels for Purposes of Assessing Risks and Designing Further Audit Procedures (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. The amount or amounts the auditor determines for purposes of assessing the risks of material misstatement and designing further audit procedures to respond to assessed risks is set to reduce to an appropriately low level the probability that the total of uncorrected and undetected misstatements in the financial statements exceeds the materiality level or levels. The determination of this amount or amounts is not a simple mechanical calculation and requires the auditor to exercise professional judgment. It is affected by the auditor’s understanding of the entity, updated during the execution of the risk assessment procedures, and by the nature and extent of misstatements accumulated in previous audits (e.g., for an entity with a history of large or numerous misstatements accumulated in previous audits, the amount or amounts so determined would be lower than if such misstatements were not present).

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

A14. The materiality level for the financial statements as a whole (or the materiality level for a particular class of transactions, account balance or disclosure, if applicable) may need to be revised as a result of a change in circumstances that occurred during the audit, 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 to determine the materiality level or levels, the auditor may need to revise the materiality level or levels.

PROPOSED INTERNATIONAL STANDARD ON AUDITING 450

(REDRAFTED)

EVALUATION OF MISSTATEMENTS IDENTIFIED DURING THE AUDIT

(Effective for audits of financial statements for periods beginning on or after [date])*

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* See footnote 5.

International Standard on Auditing (ISA) 450 (Revised), “Evaluation of Misstatements Identified during the Audit” should be read in the context of the “Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services,” which sets out the authority of ISAs.

Introduction

Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the evaluation of misstatements identified during the audit of financial statements. ISA 320, “Materiality in Planning and Performing an Audit” deals with the determination of materiality and its application in planning and performing an audit of financial statements. This ISA explains how materiality is applied in evaluating misstatements identified during the audit.

Effective Date

2. This ISA is effective for audits of financial statements for periods beginning on or after [date].⁵

Objective

3. The objective of the auditor is to evaluate:
 - (a) The effect of identified misstatements on the audit; and
 - (b) The effect of uncorrected misstatements on the financial statements and whether the financial statements as a whole are free from material misstatement.

Definitions

4. For purposes of the ISAs, the following terms have the meanings attributed below:
 - (a) Error – An unintentional misstatement in the financial statements.
 - (b) Factual misstatements – Misstatements about which there is no doubt.
 - (c) Judgmental misstatements – Differences arising from management’s judgments concerning accounting estimates that the auditor considers unreasonable, or the selection or application of accounting policies that the auditor considers inappropriate.
 - (d) Misstatement – A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud and may result from:
 - (i) An inaccuracy in gathering or processing data from which the financial statements are prepared;
 - (ii) An omission of an amount or disclosure;
 - (iii) An incorrect accounting estimate arising from overlooking or clear misinterpretation of facts; and

⁵ This date will not be earlier than December 15, 2008.

- (iv) Management’s judgments concerning accounting estimates that the auditor considers unreasonable or the selection and application of accounting policies that the auditor considers inappropriate.

When the auditor expresses an opinion on whether the financial statements give a true and fair view or are presented fairly, in all material respects, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor’s judgment, are necessary for the financial statements to give a true and fair view or present fairly, in all material respects.

- (e) Projected misstatements – The auditor’s best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn. Guidance on the determination of projected misstatements and evaluation of the results is set out in ISA 530, “Audit Sampling and Other Means of Testing.”
- (f) Uncorrected misstatements – Misstatements that the auditor has accumulated during the audit and that management has not corrected.

Requirements

Accumulation of Identified Misstatements

5. The auditor shall accumulate misstatements identified during the audit, other than those that are clearly trivial, distinguishing between factual misstatements, judgmental misstatements and projected misstatements. (Ref: Para. A1-A2)

Considerations as the Audit Progresses

6. The auditor shall consider whether the overall audit strategy and audit plan need to be revised if the nature of identified misstatements and the circumstances of their occurrence are indicative that other misstatements may exist that, when aggregated with misstatements accumulated during the audit, could be material. (Ref: Para. A3)
7. The auditor shall also determine whether the overall audit strategy and audit plan need to be revised if the aggregate of misstatements accumulated during the audit approaches the materiality level or levels. (Ref: Para. A4)
8. If management, in response to the auditor’s findings or at the auditor’s request, has examined a class of transactions, account balance or disclosure and corrected misstatements that were found, the auditor shall perform further audit procedures to reevaluate the amount of misstatements remaining, if any. (Ref: Para. A5)

Communication and Correction of Misstatements

9. The auditor shall communicate all misstatements accumulated during the audit to the appropriate level of management on a timely basis and request management to correct them. (Ref: Para. A6-A8)
10. If management refuses to correct some or all of the misstatements communicated to it by the auditor, the auditor shall obtain an understanding of management’s reasons for not making the

corrections and shall take that into account when evaluating whether the financial statements as a whole are free from material misstatement. (See paragraph 17.)

Management Representations

11. The auditor shall obtain written representation from management whether it believes the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. A summary of such items shall be included in or attached to the written representations. (Ref: Para. A9)

Evaluating the Effect of Uncorrected Misstatements

12. Prior to evaluating the effect of uncorrected misstatements, the auditor shall reassess the materiality level or levels used in planning and performing the audit to confirm whether they remain appropriate in the context of the entity’s actual financial results. (Ref: Para. A10-A11)
13. The auditor shall evaluate whether uncorrected misstatements are material, individually or in aggregate. In making this evaluation, the auditor shall consider the size and nature of the misstatements, both in relation to particular classes of transactions, account balances and disclosures and the financial statements as a whole, and the particular circumstances of their occurrence. (Ref: Para. A12-A16)
14. The auditor shall also consider the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole. (Ref: Para. A17)

Communication with Those Charged with Governance

15. The auditor shall communicate with those charged with governance⁶ uncorrected misstatements and the effect that they may have on the opinion in the auditor’s report, and request their correction. The written representation obtained from management in accordance with paragraph 11 shall form part of this communication. In communicating the effect that material uncorrected misstatements may have on the opinion in the auditor’s report, the auditor shall address them individually. (Ref: Para. A20)
16. The auditor shall communicate with those charged with governance the reasons for, and the implications of a failure to correct misstatements, having regard to the size and nature of the misstatement judged in the surrounding circumstances, including possible implications in relation to future financial statements. (Ref: Para. A21)
17. The auditor shall communicate with those charged with governance the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

⁶ In accordance with ISA 260 (Revised), “Communication with Those Charged with Governance,” if this matter has been communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, the matter need not be communicated again with those same person(s) in their governance role.

Evaluating Whether the Financial Statements as a Whole are Free from Material Misstatement

18. The auditor shall evaluate whether the financial statements as a whole are free from material misstatement. In making this evaluation, the auditor shall consider both the results of the evaluation of the uncorrected misstatements and the qualitative aspects of the entity's accounting practices. (Ref: Para. A22-23)
19. If the auditor concludes that, or is unable to conclude whether, the financial statements as a whole are materially misstated, the auditor shall consider the effect thereof on the opinion in the auditor's report. (Ref: Para. A24)

Documentation

20. The auditor shall document:
 - (a) The amount below which misstatements would be regarded as clearly trivial;
 - (b) All misstatements accumulated during the audit, distinguishing between factual misstatements, judgmental misstatements and projected misstatements, and whether they have been corrected by management; and
 - (c) The auditor's conclusion as to whether uncorrected misstatements, individually or in aggregate, cause the financial statements as a whole to be materially misstated, and the basis for that conclusion. (Ref: Para. A25)

* * *

Application and Other Explanatory Material

Accumulation of Identified Misstatements (Ref: Para. 5)

- A1. The auditor may designate an amount below which misstatements would be clearly trivial and would not need to be accumulated because the auditor expects that the accumulation of such amounts clearly would not have a material effect on the financial statements. "Clearly trivial" is not another expression for not material. Matters that are "clearly trivial" will be of a wholly different (smaller) order of magnitude than materiality used in planning and performing the audit, and will be matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances. When there is any uncertainty about whether one or more items are "clearly trivial," the matter is considered not "clearly trivial."
- A2. The distinction between factual misstatements, judgmental misstatements and projected misstatements assists the auditor in considering the effects of misstatements accumulated during the audit and in communicating them to management and those charged with governance.

Considerations as the Audit Progresses (Ref: Para. 6-8)

- A3. A misstatement may not be an isolated occurrence. Evidence that other misstatements may exist include, for example, where the auditor identifies that a misstatement arose from a breakdown

in internal control or from inappropriate assumptions or valuation methods that have been widely applied by the entity.

- A4. If the aggregate of misstatements accumulated during the audit approaches the materiality levels or levels, there may be a greater than an acceptably low level of risk that possible undetected misstatements, when taken with the aggregate of misstatements accumulated during the audit, could exceed the materiality level. Undetected misstatements could exist because of the presence of sampling risk (the risk that the auditor’s conclusion based on a sample may be different from the conclusion if the entire population was subjected to the same audit procedure) and non-sampling risk (the risk that the auditor may misinterpret audit evidence and thus not recognize misstatements when they occur).
- A5. The auditor may request management to examine a class of transactions, account balance or disclosure, for example, based on the auditor’s projection of misstatements identified in an audit sample to the entire population from which it was drawn.

Communication and Correction of Misstatements (Ref: Para. 9-10)

- A6. Timely communication of misstatements to the appropriate level of management is important as it enables management to evaluate whether the items are misstatements, inform the auditor if they disagree, and take action as necessary. Ordinarily, the appropriate level of management is the one that has responsibility and authority to evaluate the misstatements and to take the necessary action.
- A7. Laws or regulations may prevent the auditor from communicating certain misstatements to management, or others, within the entity. For example, laws or regulations may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act. In such circumstances it may be appropriate for the auditor to seek legal advice.
- A8. The correction by management of all misstatements communicated by the auditor assists management in maintaining accurate accounting books and records and reduces the risks of material misstatement of financial statements because of the cumulative effect of immaterial uncorrected misstatements related to prior periods.

Management Representations (Ref: Para. 11)

- A9. Because management is responsible for adjusting the financial statements to correct material misstatements, it is important that the auditor obtain written representation from management whether any uncorrected misstatements, other than those that are clearly trivial, are in management’s opinion immaterial, both individually and in the aggregate. In some circumstances, management may not believe that certain of the uncorrected misstatements are misstatements. For that reason, management may want to add to their written representation words such as: “We do not agree that items ... and ... constitute misstatements because [description of reasons].”

Evaluating the Effect of Uncorrected Misstatements (Ref: Para. 12-14)

- A10. The auditor’s initial determination of the materiality level or levels is often based on estimates of the entity’s financial results, because the actual financial results may not yet be known. Therefore, prior to the auditor’s evaluation of the effect of uncorrected misstatements, the

materiality level or levels used in planning and performing the audit are reassessed based on the actual financial results.

- A11. ISA 320 explains that, as the audit progresses, the materiality level or levels are revised in the event of the auditor becoming aware of information during the audit that would have caused the auditor to have determined different materiality level or levels initially. Thus, any significant revision of the materiality level or levels is likely to have been made before the auditor applies the materiality level or levels in evaluating the effect of uncorrected misstatements. However, as explained in ISA 320, if the materiality level or levels are revised to lower amount or amounts, the lower amount or amounts determined for purposes of assessing risks of material misstatements and designing further audit procedures, and the appropriateness of the nature, timing and extent of further audit procedures, are reconsidered to ensure that sufficient appropriate audit evidence is obtained on which to base the audit opinion.
- A12. Each misstatement is considered separately to evaluate its effect on the relevant classes of transactions, account balances or disclosures, including whether the materiality level for that particular class of transactions, account balance or disclosure, if any, has been exceeded.
- A13. If an individual misstatement is judged to be material, it is unlikely that it can be offset by other misstatements. For example, if revenue has been materially overstated, the financial statements as a whole will be materially misstated, even if the effect of the misstatement on earnings is completely offset by an equivalent overstatement of expenses. It may be appropriate to offset immaterial misstatements within an account balance or class of transactions; however, the risk that further undetected misstatements may exist is considered before concluding that offsetting such immaterial misstatements is appropriate.⁷
- A14. Determining whether a classification misstatement is material requires the use of professional judgment and the evaluation of qualitative considerations, such as the effect of the classification misstatement on debt or other contractual covenants, the effect on individual line items or sub-totals on the effect on key ratios. There may be circumstances where the auditor concludes that a classification misstatement is not material in the context of the financial statements as a whole, even though it may exceed the materiality level or levels applied in evaluating other misstatements. For example, a misclassification between balance sheet line items may not be considered material in the context of the financial statements as a whole when the amount of the misclassification is small in relation to the size of the related balance sheet line items and the misclassification does not affect the income statement or any key ratios.
- A15. The circumstances related to some misstatements may cause the auditor to evaluate them as material, individually or when considered together with other misstatements accumulated during the audit, even if they are lower than the materiality level for the financial statements as a whole (or for a particular class of transactions, account balance or disclosure, if any). Circumstances that may affect the evaluation include the extent to which the misstatement:
- Affects compliance with regulatory requirements;
 - Affects compliance with debt covenants or other contractual requirements; or

⁷ The identification of a number of immaterial misstatements within an account balance or class of transactions may require the auditor to reassess the risk of material misstatement for that account balance or class of transactions.

- Relates to the incorrect selection or application of an accounting policy that has an immaterial effect on the current period's financial statements but is likely to have a material effect on future periods' financial statements.
- Masks a change in earnings or other trends, especially in the context of general economic and industry conditions;
- Affects ratios used to evaluate the entity's financial position, results of operations or cash flows;
- Affects segment information presented in the financial statements (e.g., the significance of the matter to a segment or other portion of the entity's business that has been identified as playing a significant role in the entity's operations or profitability);
- Has the effect of increasing management compensation, for example, by ensuring that the requirements for the award of bonuses or other incentives are satisfied;
- Is a misclassification between certain account balances affecting items disclosed separately in the financial statements (e.g., misclassification between operating and non-operating income or recurring and non-recurring income items; or a misclassification between restricted and unrestricted resources in a not-for-profit entity);
- Is significant having regard to the auditor's understanding of known previous communications to users, for example in relation to forecast earnings;
- Relates to items involving particular parties (e.g., whether external parties to the transaction are related to members of the entity's management);
- Is an omission of information not specifically required by the applicable financial reporting framework but which, in the judgment of the auditor, is important to the users' understanding of the financial position, financial performance or cash flows of the entity;
- Affects other information that will be communicated in documents containing the audited financial statements (e.g., information to be included in a "Management Discussion and Analysis" or an "Operating and Financial Review") that may reasonably be expected to influence the economic decisions of the users of the financial statements. ISA 720, "Other Information in Documents Containing Audited Financial Statements" deals with the auditor's consideration of other information, on which the auditor has no obligation to report, in documents containing audited financial statements.

These circumstances are only examples; not all are likely to be present in all audits nor is the list necessarily complete. The existence of any circumstances such as these does not necessarily lead to a conclusion that the misstatement is material.

A16. ISA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" explains how the implications of a misstatement that is, or may be, the result of fraud ought to be considered in relation to other aspects of the audit, even if the effect of the misstatement is not material to the financial statements.

A17. The cumulative effect of immaterial uncorrected misstatements related to prior periods may have a material effect on the current period's financial statements. There are different acceptable approaches to the auditor's evaluation of such uncorrected misstatements on the

current period’s financial statements. Using the same evaluation approach provides consistency from period to period.

Considerations Specific to Public Sector Entities (Ref: Para. 12-14)

A18. In the case of an audit of a public sector entity, the evaluation of the materiality of a misstatement may also be affected by legislation or regulation and additional responsibilities for the auditor to report other matters, including, for example, fraud.

A19. Furthermore, issues such as public interest, accountability, probity and ensuring effective legislative oversight, in particular, are considered when assessing whether an item is material by virtue of its nature. This is particularly so for items that relate to compliance with regulation, legislation or other authority.

Communication with Those Charged with Governance (Ref: Para. 15-16)

A20. Where there is a large number of small uncorrected misstatements, the auditor may communicate the number and overall monetary effect of the uncorrected misstatements, rather than the details of each individual uncorrected misstatement.

A21. To reduce the possibility of misunderstandings, the auditor may request a written representation from those charged with governance that explains why uncorrected misstatements brought to their attention have not been corrected. Obtaining this representation does not, however, relieve the auditor of the need to form a conclusion on the effect of uncorrected misstatements.

Evaluating Whether the Financial Statements as a Whole are Free from Material Misstatement (Ref: Para. 18-19)

A22. In considering the qualitative aspects of the entity’s accounting practices, the auditor recognizes that management makes a number of judgments about the amounts and disclosures in the financial statements. During the audit, the auditor is alert for possible bias in management’s judgments. The auditor may conclude that the cumulative effect of a lack of neutrality, together with the effect of uncorrected misstatements, cause the financial statements as a whole to be materially misstated. Indicators of a lack of neutrality that may affect the auditor’s evaluation whether the financial statements as a whole are materially misstated include the following:

- The selective correction of misstatements brought to management’s attention during the audit (e.g., correcting misstatements with the effect of increasing reported earnings, but not correcting misstatements that have the effect of decreasing reported earnings).
- Possible management bias in the making of accounting estimates.

A23. ISA 540 (Revised), “Auditing Accounting Estimates and Related Disclosures (Other Than Those Involving Fair Value Measurements and Disclosures)” addresses possible management bias in making accounting estimates. Indicators of possible management bias do not constitute misstatements for purposes of drawing conclusions on the reasonableness of individual accounting estimates. They may, however, affect the auditor’s evaluation of whether the financial statements as a whole are free from material misstatement.

A24. ISA 705, “Modifications to the Opinion in the Independent Auditor’s Report” deals with circumstances that may result in a modification to the auditor’s opinion on the financial

statements, the type of opinion appropriate in the circumstances, and the content of the auditor's report when the auditor's opinion is modified.

Documentation (Ref: Para. 20)

A25. The following factors may affect the manner in which the auditor documents the auditor's conclusion, and the basis thereof, as to whether uncorrected misstatements, individually or in the aggregate, cause the financial statements as a whole to be materially misstated:

- (a) The consideration of the aggregate effect of uncorrected misstatements on the financial statements as a whole;
- (b) The evaluation of whether the materiality level for a particular class of transactions account balance or disclosure, if any, has been exceeded; and
- (c) The evaluation of the effect of uncorrected misstatements on key ratios or trends, and compliance with legal, regulatory and contractual requirements (e.g., debt covenants).



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