

Mark up copy showing changes from draft presented at the July 2003 meeting
(Discussion in the April 2004 meeting will be based on the clean copy)

MATERIALITY IN THE IDENTIFICATION AND EVALUATION OF MISSTATEMENTS

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International Standards on Auditing (ISAs) 320 “Materiality in the Identification and Evaluation of Misstatements” should be read in the context of the “Preface to the International Standards on Quality Control, Auditing, Assurance and Related Services”, which sets out the application and authority of ISAs. ~~are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.~~

~~ISAs contain the basic principles and essential procedures (identified in bold type black lettering) together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be interpreted in the context of the explanatory and other material that provide guidance for their application.~~

~~To understand and apply the basic principles and essential procedures together with the related guidance, it is necessary to consider the whole text of the ISA including explanatory and other material contained in the ISA, not just that text which is black lettered.~~

~~In exceptional circumstances, an auditor may judge it necessary to depart from an ISA in order to more effectively achieve the objective of an audit. When such a situation arises, the auditor should be prepared to justify the departure.~~

~~ISAs need only be applied to material matters.~~

~~The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an ISA. Where no PSP is added, the ISA is applicable in all material respects to the public sector.~~

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish basic principles and essential procedures~~standards~~ and to provide guidance on materiality, including its relationship with audit risk and ~~its relevance to~~how it is used in the identification and evaluation of misstatements when performing an audit of financial statements.

Nature and Causes of Misstatements

2. A misstatement causes the financial statements to be not in accordance with the applicable financial reporting framework. Misstatements, which can arise unintentionally or intentionally, may consist of:

- (a) An inaccuracy in gathering or processing data from which financial statements are prepared;
- (b) A difference between the amount, classification, or presentation of a reported financial statement item and the amount, classification, or presentation that is required for the item to be in accordance with the applicable financial reporting framework;
- (c) An omission of an amount or disclosure that is required by the applicable financial reporting framework;
- (d) An omission of relevant information not specifically contemplated by the applicable financial reporting framework but which, in the judgment of the auditor, is necessary for the financial statements to give a true and fair view (or present fairly, in all material respects);¹
- (e) An incorrect accounting estimate arising, for example, from an oversight or misinterpretation of facts; and
- (f) Differences between management's and the auditor's judgments concerning accounting estimates,² or the selection and application of accounting policies, that the auditor considers inappropriate.

3. In extremely rare circumstances, compliance with a specific requirement in the applicable financial reporting framework itself may result in financial statements that are so misleading that they fail to give a true and fair view (or present fairly, in all material respects) and, therefore, are considered to be materially misstated.³

~~2. The auditor should consider materiality:~~

~~(a) (a) — When assessing audit risk;~~

¹ [Proposed revised] ISA 700, "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements" provides guidance on the auditor's considerations in these circumstances.

² The evaluation of such differences in judgment concerning accounting estimates, including whether they are considered to be misstatements and, if so, how the amount of misstatement is measured, is addressed in proposed revised ISA 540. See ISA 540, "The Audit of Accounting Estimates and Related Disclosures (Other Than Those Involving Fair Value Measurements and Disclosures)".

³ [Proposed revised] ISA 700, "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements" provides guidance on the auditor's considerations in these circumstances.

- ~~(b) When determining the nature, timing and extent of audit procedures;~~
- ~~(c) As the audit progresses; and~~
- ~~(d) When evaluating the effect of identified misstatements on the auditor's report.~~

Materiality in the Context of an Audit

4. The auditor should consider materiality:

- (a) When determining the nature and extent of risk assessment procedures to obtain an understanding of the entity and its environment, and when identifying and assessing the risks of material misstatement;
- (b) When determining the nature, timing and extent of further audit procedures; and
- (c) When evaluating the effect of identified misstatements on the auditor's report.

35. The auditor should consider a misstatement, or an aggregate of misstatements, information to be material if, in the judgment of the auditor, it is probable that the effect of the misstatement, or aggregate misstatements, which includes omission, would reasonably change or influence economic decisions, taken on the basis of the audited financial statements as a whole, by users who have a reasonable understanding of business and economic activities and financial reporting. In deciding whether an item misstatement or an aggregate of items misstatements is material, the auditor should consider both the nature and size and nature of the misstatement item or items aggregate misstatements judged in the particular circumstances of their misstatement of their occurrence.

USERS

64. There are many potential users of financial statements. The auditor ordinarily cannot be aware of all the potential users or of their different needs for information presented in accordance with the financial reporting framework. When making decisions about the purpose of determining materiality for the audit of a complete set of general purpose financial statements, the auditor forms a judgment of the effect of misstatements on the economic decisions of the user group to whom the auditor's report is addressed; the auditor does not consider the possible effect of misstatements on specific individual users, which may vary widely. When determining materiality for financial statements designed to meet the financial reporting needs of specific users, the auditor forms this judgment in the context of the auditor's understanding of the needs of those specific users.

ut materiality the auditor has regard to the perceived needs of:

- The intended users of the auditor's report, as described in paragraphs 17 to 19 of the "International Framework for Assurance Engagements"; and
- Other users to whom the auditor has a known duty of care.⁴

⁴ The extent of the auditor's duty of care is dependent upon the laws, and interpretations thereof by the Courts, in the country in which the auditor's report is issued. The absence of a restriction regarding a particular user or class of user does not indicate that a duty of care is owed by the auditor to that user or class of user.

~~As investors are providers of risk capital, consideration of their perceived needs will generally also meet most of the needs of other users of the financial statements.~~

~~5. Obtaining the views and expectations of management and those charged with governance may be helpful in gaining or corroborating an understanding of users' needs.~~

~~76. The presentation of information in the financial statements is determined by the applicable financial reporting framework. The requirements of the applicable financial reporting framework determine the form and content of the financial statements. In making judgments about materiality, the auditor assumes that users have a reasonable understanding of business, economic activities and financial reporting; and in particular that they:~~

~~(a) Are capable of understanding information that is presented in accordance with the applicable financial reporting framework;~~

~~(b) Will understand that there is a relationship between the level of materiality used and the cost and timing of the audit, and recognize that, to be economically useful, the auditor's opinion needs to be derived within a reasonable period of time and at a reasonable cost;~~

~~(c) Will recognize the uncertainties inherent limitations in the measurement of amounts based on the use of estimates, judgment and the consideration of future events;~~

~~(d) Will study the information with reasonable diligence; and~~

~~(e) Will make reasonable decisions on the basis of that information.~~

CLASSIFICATION OF MISSTATEMENTS

~~7. Financial statements ordinarily are not prepared to meet all the potential information needs of users. Users may have to supplement the information they obtain from the audited financial statements with information from other sources.~~

EXTENT OF AUDITOR'S RESPONSIBILITY

~~8. In planning and performing the audit, the auditor is primarily concerned with identifying matters that could result in material misstatement in the financial statements. The auditor has no responsibility to plan and perform the audit to detect misstatements, whether caused by errors or fraud, that are not material, individually or in aggregate, to the financial statements.~~

~~9. Those who are responsible for approving and issuing the financial statements are responsible for adjusting the financial statements to correct misstatements, and for decisions to waive misstatements they believe are not material. The auditor considers the effect of uncorrected misstatements, individually and in the aggregate, on the auditor's report.~~

Nature and Causes of Misstatements

~~10. Misstatements in the financial statements can arise from error or fraud. The term "error" refers to an unintentional misstatement in financial statements. The term "fraud" refers to an intentional act by one or more individuals among those charged with governance, management, employees, or third parties, involving the use of deception to obtain an unjust~~

or illegal advantage. The auditor's consideration of fraud is addressed in ISA 240 "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements".

~~11. A misstatement ordinarily causes the financial statements to be not in accordance with the applicable financial reporting framework. Misstatements may consist of:~~

- ~~(a) A mistake in gathering or processing data from which financial statements are prepared;~~
- ~~(b) A difference between the amount, classification, or presentation of a reported financial statement item and the amount, classification, or presentation that should have been reported under the financial reporting framework;~~
- ~~(c) An omission of an amount, classification or disclosure that should have been reported under the applicable financial reporting framework;~~
- ~~(d) An incorrect accounting estimate arising from an oversight or misinterpretation of facts; and~~
- ~~(e) Differences between management's and the auditor's judgments concerning accounting estimates,⁵ or the application of accounting principles.~~

~~[12. Misstatements also include, in exceptional circumstances, items that comply with the applicable financial reporting framework but cause the financial statements not to give a true and fair view of (or present fairly) the financial position of the entity (e.g. where it is necessary to override the requirements of accounting standards in order to give a true and fair view (or present fairly) but this is not done).]~~

813. Misstatements are classified for audit purposes as:

(a) Known misstatements

These are specific misstatements identified during the audit including, for example, those arising from mistakes in gathering or processing data and, in the context of accounting estimates, the oversight or misinterpretation of facts. Their existence is not in doubt.

(b) Likely misstatements

These are misstatements that estimated by the auditor consider that most likely to exist based on an extrapolation from audit evidence obtained. For example, the amount obtained by the projected projecting effect of known misstatements identified in an audit sample sample to the entire population from which the sample was drawn.

(c) Misstatements arising from Differences differences in judgment

These are those differences between management's and the auditor's judgments concerning accounting estimates, or the selection and application of accounting principles policies, that the auditor considers to be misstatements (e.g. because an estimate included in the financial statements by management is outside of the range of

⁵ See proposed revised ISA 540, "The Audit of Accounting Estimates (Other Than Those Involving Measurement at Fair Value)".

reasonably possible outcomes the auditor has determined; or, when the auditor considers an accounting policy selected and applied by the entity to be inappropriate).

The Relationship Between Materiality and Audit Risk

9. Materiality and audit risk need to be considered together throughout the audit and, in particular, in planning and evaluating the results of audit procedures. Decisions concerning materiality and audit risk are among the most significant made in the course of the audit because they form the basis for determining the nature, timing and extent of the further audit procedures to be performed and evaluating the results of those procedures.
10. The auditor's consideration of materiality affects the auditor's decisions regarding the risk assessment procedures to be performed to obtain an understanding of the entity and its environment, including its internal control, and in identifying and assessing the risks of material misstatement. ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement" requires the auditor to assess the risks of material misstatement at the financial statement level, and at the assertion⁶ level for classes of transactions, account balances and disclosures. The auditor's risk assessment then serves as the basis for determining the nature, timing and extent of further audit procedures to reduce the risks of material misstatement to an acceptably low level. Throughout the audit and in forming the auditor's conclusions, materiality and audit risk are also considered in evaluating whether, as a result of the auditor's procedures, the auditor has obtained reasonable assurance that the financial statements taken as a whole are free from material misstatement.

Determining Materiality

- ~~11. The evaluation of what is material is a matter of professional judgment. In order to assess the risks of material misstatement, and to plan the nature, timing and extent of audit procedures, the auditor should determine a materiality level for the financial statements taken as a whole for the purpose of:~~
 - (a) Determining the extent and nature of risk assessment procedures to obtain an understanding of the entity and its environment;
 - (b) Identifying and assessing the risks of material misstatement;
 - (c) Determining the nature, timing and extent of further audit procedures; and
 - (d) Evaluating the effect of identified misstatements.
12. The auditor should also consider whether, in the specific circumstances of the entity, misstatements of particular items of lesser amounts than this materiality level, if any, would, in the auditor's judgment, reasonably change or influence economic decisions of

⁶ The concept of assertions is explained in ~~paragraph 7 of~~ ISA ~~XX-500 (Revised)~~. "Audit Evidence." Broadly, they are the assertions made implicitly by management in financial statements relating to recognition and measurement of the various elements of financial statements and related disclosures (e.g. that transactions have been recorded in the correct period; that assets exist and are appropriately valued and the entity holds or controls the rights to them).

users taken on the basis of the financial statements as a whole.~~he auditor should determine materiality~~

~~at the overall financial statement level and at the level of individual classes of transactions, account balances and disclosures. Materiality levels should be determined taking into account the auditor's understanding of the importance to users of different items disclosed in the financial statements, having regard to the size and nature of those items judged in the particular circumstances.~~

13. The determination of what is material is a professional judgment. In practice, materiality is not a fine line where one dollar less is not material or one dollar more is material, nor is it limited to considering the size of the item alone.

14. Materiality is determined without regard to the degree of inherent uncertainty associated with the measurement of particular items. For example, if the financial statements include very large provisions with a high degree of measurement uncertainty⁷ (e.g. for insurance claims in the case of an insurance company, oil rig decommissioning costs in the case of an oil company, or, more generally, legal claims against an entity) the auditor does not determine that the materiality level for the financial statements taken as a whole is higher than the level that would be determined if the financial statements did not include such measurement uncertainties in relation to those provisions.

MATERIALITY FOR THE FINANCIAL STATEMENTS TAKEN AS A WHOLE

15. ~~ISA XX "Understanding the Entity and Its Environment and Assessing the Risk of Material Misstatement" requires the auditor to assess the risks of material misstatement at two levels: at the overall financial statement level, and at the assertion level for classes of transactions, account balances and disclosures. However, the auditor does not determine separate materiality levels for each separate assertion: the auditor uses the levels of materiality that the auditor has determined apply to individual classes of transactions, account balances and disclosures (see below).~~

16. ~~The auditor expresses an opinion on the financial statements taken as a whole, not on individual classes of transactions, account balances and disclosures. Nonetheless, users of the audited financial statements may be more sensitive to misstatements in relation to certain classes of transactions, account balances and disclosures than in relation to others, and to the trends and ratios that may be derived from them. Accordingly, when determining materiality levels and assessing the risks of material misstatement, in addition to considering materiality at the overall financial statement level, the auditor considers whether there are particular classes of transactions, account balances and disclosures for which different lower levels of materiality are appropriate for use in planning, and evaluating, audit procedures. This results typically in more than one level of materiality being established (although it is not, ordinarily, necessary to separately determine individual materiality levels for every item in the financial statements).~~

⁷ [Note to the IAASB: "Measurement uncertainty" is used for consistency with the Accounting Estimates Task Force. The term was taken from an IASB Exposure Draft revising IAS 1, "Presentation of Financial Statements". The revised IAS 1 (issued in December 2003) uses the term "estimation uncertainty".]

~~17. The materiality level for a particular class of transaction, account balance or disclosure cannot be greater than materiality at the overall financial statement level. Where two or more classes of transaction or account balance are related such that a misstatement of one is matched by misstatement of the other(s), the auditor determines materiality for each of those classes of transaction or account balance at the lowest level appropriate to any one of them.~~

~~18. When considering the importance to users of different items disclosed in the financial statements the auditor has regard to circumstances such as:~~

- ~~• The requirements of the applicable financial reporting framework (e.g. whether accounting standards and guidance contain explicit references to the judgment of materiality of particular items);~~
- ~~• The nature of the entity, the industry in which it operates and, in relation thereto, key disclosures, trends, ratios and other financial indicators (e.g. matters pertaining to the solvency ratio of an insurance company);~~
- ~~• The size of the entity and nature of its stakeholders, the way the entity is financed and whether or not it is listed on a regulated market; and~~
- ~~• Information communicated by management or external analysts that may affect users' expectations, and the auditor's awareness of users' reactions to similar previously published information.~~

~~1519. The auditor may select benchmarks on which to base the initial evaluations determination of materiality for the financial statements taken as a whole on an appropriate benchmark. When identifying an appropriate benchmarks, the auditor has regard to factors such as:~~

- ~~• The requirements of the applicable financial reporting framework;~~
- ~~• Whether there are financial statement items on which, for the particular entity, users' attention tends to be focused (e.g. for the purpose of evaluating financial performance);~~
- ~~• The nature of the entity and the industry in which it operates; and~~
- ~~• The size of the entity, nature of its ownership, and the way it is financed.~~

~~Examples of benchmarks that might be appropriate, depending on the nature and circumstances of the entity, include total revenues, gross profit and other categories of reported income, such as the perceived needs of the users of the financial statements and the entity's particular circumstances. Income after tax from continuing operations or profit from ordinary activities. Profit from ordinary activities may be of may be a suitable benchmark particular significance to the financial statement users or for profit oriented entities whose equity securities are publicly traded but may and this may be a suitable benchmark on which to base materiality at the overall financial statement level. Income after tax may not be an appropriate benchmark for the determination of materiality when, for example, the entity's earnings are volatile, when the entity is a not-for-profit organization or when it is an owner managed business where the owner takes much of the pre-tax income out of the business in the form of remuneration. Other benchmarks that, depending on the circumstances, may be appropriate include Other benchmarks that might be appropriate, depending on the circumstances of the entity, include current assets, net working capital, total assets, total liabilities, total revenues, gross profit, total equity, and cash flows from operations.~~

16. When determining materiality based on a benchmark, the auditor ordinarily considers prior periods' financial results and financial positions, the period-to-date financial results and financial position, and budgets or forecasts for the current period, taking account of significant changes in the entity's circumstances (e.g. a significant business acquisition) and relevant changes of conditions in the economy as a whole or the industry in which the entity operates.
- ~~20. When considering appropriate benchmarks the auditor also considers whether there are risks of overstatement or understatement and the effect that may have on the determination of materiality. For example, a materiality level may be inappropriately large if it is based on a benchmark that is overstated.~~

MATERIALITY FOR PARTICULAR ITEMS OF LESSER AMOUNTS THAN THE MATERIALITY LEVEL DETERMINED FOR THE FINANCIAL STATEMENTS TAKEN AS A WHOLE

17. When considering whether, in the specific circumstances of the entity, misstatements of particular items of lesser amounts than the materiality level determined for the financial statements taken as a whole, if any, would reasonably change or influence the economic decisions of users of the financial statements, the auditor considers factors such as:
- Whether accounting standards, law or regulations affect users' expectations of the degree of accuracy of certain items (e.g. disclosures of related party transactions and the remuneration of management and those charged with governance);
 - The key disclosures in relation to the industry and the environment in which the entity operates (e.g. research and development costs for a pharmaceutical company and matters pertaining to the solvency ratio for an insurance company);
 - Whether attention is focused on the financial performance of a particular business segment that is separately disclosed in the financial statements (e.g. for a newly acquired business).
18. Obtaining an understanding of the views and expectations of, inter alia, -those charged with governance, and of management, may help the auditor judge whether, in the specific circumstances of the entity, misstatements of particular items of lesser amounts than the materiality level for the financial statements taken as a whole, if any, would reasonably change or influence economic decisions of users taken on the basis of the financial statements.
- ~~21. In relation to particular classes of transactions, account balances and disclosures, the auditor considers whether there is an amount above which any item would always be considered by the users to be material, having regard to the nature of the item and the circumstances in which it is judged.~~
- ~~22. The intrinsic nature of some items may cause them to be judged material even when they have a relatively small size. For example:~~
- ~~(a) Those where there are concerns about the legality, sensitivity and normality of the event or transaction and the potential consequences;~~

- ~~(b) The inadequate or improper description of an accounting policy when it is likely that a user of the financial statements would be misled by the description;~~
- ~~(c) Failure to disclose the breach of contractual or regulatory requirements when it is likely that the consequent imposition of contractual or regulatory restrictions may significantly impair operating capability;~~
- ~~(d) Matters that affect the integrity of the financial records;~~
- ~~(e) Matters which suggest fraudulent financial reporting practice (see ISA 240), or that management is attempting to “manage” or manipulate the entity's reported earnings or trends and key financial indicators. For example, intentional misstatements could be used by management as a means of achieving forecast results.~~

ASSESSING THE RISKS OF MATERIAL MISSTATEMENT AT THE ASSERTION LEVEL AND PLANNING FURTHER AUDIT PROCEDURES

19. ISA 315 requires the auditor to identify and assess the risks of material misstatement at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures. When assessing the risks of material misstatement at the assertion level, and designing and performing further audit procedures to respond to those assessed risks, the auditor allows for the possibility that misstatements of lesser amounts than the materiality level determined for the financial statements as a whole could, in the aggregate, result in a material misstatement of the financial statements. To make this allowance the auditor uses professional judgment to determine levels of tolerable misstatement⁸ for classes of transactions, account balances and disclosures.
20. The level of tolerable misstatement for a particular class of transaction, account balance or disclosure cannot be higher than the materiality level that the auditor has determined for the financial statements taken as a whole or, if applicable, the lower materiality level determined for a particular class of transactions, account balance or disclosure (see paragraphs 12 and 17) and ordinarily is lower.
- ~~23. Ordinarily, when making preliminary judgments about materiality, the auditor considers prior period financial results, period to date financial results, and budgets or forecasts for the current period, taking account of known changes in the business. Where the draft current period financial results appear to be significantly different to previous periods, the auditor considers the reason for that. If draft financial results for the current period are not yet available for planning purposes, the auditor considers making preliminary judgments about materiality based on the entity's annualized interim financial statements or financial statements of one or more prior annual periods, adjusting if necessary for the effects of significant changes in the entity's circumstances (e.g. a significant business acquisition) and relevant changes in the economy as a whole or the industry in which the entity operates.~~

⁸ When planning and performing a test of details the auditor may determine a level of “tolerable error” (the maximum error in a population that the auditor is willing to accept) as described in ISA 530, “Audit Sampling and Other Selective Testing Procedures.” Such a tolerable error cannot be greater than the tolerable misstatement the auditor has determined for the particular class of transactions or account balances being audited and may be less (e.g. where a test of details is only applied to part of a particular class of transactions or account balance).

Considerations as the Audit Progresses

214. The auditor should reconsider the appropriateness of the materiality levels, revising ~~them~~it if necessary, in the event of becoming aware of information during the audit that would have caused a different levels to have been determined initially.

~~2225.~~ The auditor's ~~evaluation-determination~~ of materiality at the time of ~~initially~~ planning the audit may differ from that at the time of evaluating the results of further audit procedures. This may be because of a change in circumstances that occurs during the audit or because of new information or changes in the auditor's understanding of the entity and its operations as a result of performing further audit procedures. For example, the auditor might have based materiality on the anticipated period end financial results. If actual financial results are substantially different, the ~~evaluation-determination~~ of materiality may also change.

~~2326.~~ If, ~~after planning the audit procedures,~~ the auditor concludes that, based on new information, determines that the a lower relevant acceptable materiality level ~~is lower, than that initially used to plan the further audit procedures is appropriate, -audit risk is increased.~~ the auditor reconsiders the appropriateness of the nature, timing and extent of those audit procedures. ~~-compensates for this by:~~

- ~~(a) Reducing the assessed risk of material misstatement, where this is possible, by performing extended or additional tests of the operating effectiveness of internal controls; or~~
- ~~(b) Modifying the nature, timing and extent of planned substantive procedures, for example by performing tests of details as opposed to substantive analytical procedures, performing substantive procedures closer to period end, and/or increasing the extent of substantive procedures.~~

~~2427.~~ The auditor should also consider evaluates whether ~~known and likely misstatements~~ misstatements are material, individually and in aggregate, as they are identified. The auditor should also consider whether identified misstatements are isolated occurrences or whether there is evidence that other misstatements may exist that, when aggregated with identified misstatements, would be material.

25. 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. In such circumstances the auditor evaluates whether the nature, timing and extent of further audit procedures need to be reconsidered to reduce audit risk to an acceptably low level.

26. The circumstances related to some misstatements may cause the auditor to evaluate them as material, individually or in aggregate, even if they are of a lower level than the auditor had determined to be material when planning the audit. Circumstances that may affect the evaluation include whether the misstatement:

- Affects compliance with regulatory requirements;
- Affects compliance with debt covenants or other contractual requirements;
- 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 pervasive, affecting the presentation of numerous items in the financial statements;
- Is a misclassification between particular account balances (e.g. misclassification between operating and non-operating income or recurring and non-recurring income items; a misclassification between restricted and unrestricted resources in a not-for-profit organization; or a misclassification between balance sheet items that may not affect income);
- Is significant relative to the auditor's understanding of users' expectations. For example, where particular levels of forecast earnings have previously been communicated to users by management;
- 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; or
- 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 affect the expectations of the users of the financial statements.

The existence of circumstances such as these does not always lead to a conclusion that a misstatement is material. The auditor considers whether, in the circumstances, it is probable that the effect of the misstatement would reasonably change or influence economic decisions, taken on the basis of the audited financial statements as a whole, by users who have a reasonable understanding of business, economic activities and financial reporting.

27. If the auditor concludes that ~~the identified~~ misstatements are, or in the case of likely misstatements may be, material, the auditor ~~considers requests~~ management to undertake further work to identify other misstatements that may exist (see paragraphs 33 and 34). ~~reducing audit risk by extending audit procedures (see also paragraphs 58–64 of ISA XX "The Auditor's Procedures in Response to Assessed Risks").~~

AFDJEM**Documentation and Communication of Misstatements With Management and Those Charged With Governance**COMMUNICATION OF MATERIALITY

28. The auditor should communicate to those charged with governance the materiality level the auditor determined for the financial statements taken as a whole and the basis on which the materiality level was determined. The auditor should also communicate to those charged with governance details of particular items, if any, for which the auditor judged that misstatements of lesser amounts than this materiality level would reasonably change or influence economic decisions of users taken on the basis of the financial statements as a whole.

29. The auditor ordinarily discusses with those charged with governance the application of materiality in the audit as part of a broader communication of the general approach and overall scope of the audit.⁹ The auditor explains that the circumstances related to some misstatements may cause the auditor to evaluate them as material, individually or in aggregate, even if they are of a lower level than the auditor had determined to be material when planning the audit.

COMMUNICATION OF MISSTATEMENTS

3028. The auditor should ~~document~~ communicate all misstatements identified during the audit, other than those that the auditor believes are clearly trivial,¹⁰ and communicate them to the appropriate level of management on a timely basis, unless prevented from doing so by law.

29. ~~Misstatements are documented in a manner that allows the auditor to:~~

- ~~(a) Separately consider the effects of known misstatements, likely misstatements and differences in judgment on the financial statements;~~
- ~~(b) Consider the effects of individual misstatements and aggregated misstatements on the financial statements; and~~
- ~~(c) Assess the effect of misstatements on particular groups of accounts, segment information, ratios, trends and compliance with debt covenants.~~

~~An illustrative example of a schedule of unadjusted misstatements is set out in Appendix 1.~~

⁹ ISA 260, “Communication of Audit Matters With Those Charged With Governance” indicates that audit matters of governance interest communicated to the those charged with governance ordinarily include the general approach and overall scope of the audit.

¹⁰ This is not another expression for not material. Matters which are “clearly ~~trifling~~trivial” will be of a wholly different (smaller) order of magnitude than the materiality levels used in the audit, and will be matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, ~~and/or~~ nature or circumstances. Further, whenever there is any uncertainty about whether one or more items are “clearly ~~trifling~~trivial” (in accordance with this definition), the auditor presumption presumes ~~should be~~ that the matter is not “clearly ~~trifling~~trivial”.

~~30. The auditor also documents those matters identified which, although not considered to be misstatements, may otherwise be relevant to the auditor's report because of their nature (e.g. matters such as those identified in paragraph 22, or an indication of a possible pattern of bias by management when developing and accumulating accounting estimates). An illustrative example of a summary of other audit findings is set out in Appendix 2.~~

~~31~~³⁴. Communication of misstatements to the appropriate level of management on a timely basis is important as it enables management to evaluate for themselves whether the items are misstatements, or to inform the auditor if they disagree, and to take action as necessary (e.g. to correct known misstatements and to undertake actions that could reduce the amount of likely misstatements identified by the auditor). The determination of which level of management is the appropriate one is a matter of professional judgment and is affected by such factors as the nature, size and frequency of the misstatement. ~~Ordinarily, the appropriate level of management is at least one level above the persons who appear to be involved with the misstatement.~~

32. In some jurisdictions there may be circumstances where the auditor is prevented by law from communicating misstatements, or other matters, to management, or others, within the entity. For example, national laws may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act (e.g. where the communication, or other action, could alert the perpetrator of an illegal act to the fact that it had been detected). In such circumstances the auditor ordinarily seeks legal advice.

33². **The auditor should encourage request management to correct all known misstatements and misstatements arising from differences in judgment, other than those that the auditor believes are clearly trivial. Where appropriate, the auditor also requests management to take action to reduce the estimated amount of likely misstatements.**

~~34. estimated~~ Where the auditor ~~estimated~~ estimates the amount of likely misstatement in a class of transactions, account balance or disclosure and that estimate is material, either individually or in aggregate with other misstatements, the auditor discusses with management the consequences for the auditor's report if management fails to review the class of transactions, account balance or disclosure and, if possible, identify and correct misstatements found. When management takes action and corrects identified misstatements that are found through this review, the auditor then performs further audit procedures to reevaluate the level of likely misstatements in the class of transactions, account balance or disclosure, undertakes more audit procedures to reduce the uncertainty of the amount of estimated likely misstatements and/or asks to

~~35. When known misstatements identified by the auditor are not corrected by management, the~~ The auditor should communicate misstatements that management declines to correct all such uncorrected known misstatements, other than those that the auditor believes are clearly trivial, together with identified likely misstatements and differences in judgment, other than those that the auditor believes are clearly trifling, to those charged with governance, unless they are the same persons as management (as may be the case in smaller entities), in accordance with ISA 260, "Communication of Audit Matters to Those Charged with Governance". The auditor should also consider

whether the auditor has a responsibility to the need to report certain misstatements, in some circumstances, to regulatory and enforcement authorities.¹¹

36. In communications with those charged with governance, misstatements are not dismissed as immaterial solely because they are of a lesser amount than the auditor determined as the materiality level for the financial statements taken as a whole when planning the audit. As described in paragraph 26 above, the circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are of a lesser amount than the auditor had determined to be material when planning the audit. Material misstatements are addressed individually and the auditor explains to those charged with governance why the auditor considers them to be material.
37. Where it aids the communication process, the auditor may communicate a summary of those uncorrected misstatements that the auditor judges to be immaterial in aggregate (e.g. by informing those charged with governance of the number and overall sum of immaterial misstatements) rather than communicating the details of each individual misstatement.
38. The auditor discusses with those charged with governance management's reasons for not correcting the misstatements, the implications for the auditor's report and the possible implications in relation to future financial statements if they remain uncorrected (e.g. where, although immaterial in the current period, the accumulation of such misstatements over time could lead to an aggregate material misstatement in the future). Where the auditor considers it appropriate, the auditor requests those charged with governance to ask management to correct the misstatements.
- ~~33. The auditor discusses known misstatements that have not been corrected by management and likely misstatements and differences in judgment with those charged with governance. Consideration is given to the nature and circumstances as well as the size of the misstatements, and the effect of such misstatements on the auditor's report.~~
- ~~3394. If management has corrected known misstatements, the auditor considers whether misstatements that management has previously corrected, any of those corrections of which the auditor is aware, should be communicated to those charged with governance so as to assist them to fulfill their governance responsibilities. It (e.g. may be helpful to communicate material misstatements that have been previously corrected by management, or frequently recurring immaterial misstatements which, although corrected, may be indicative of significant weaknesses in the systems of internal control or the design or operation of the entity's financial reporting process).~~

COMMUNICATION OF QUALITATIVE ASPECTS OF THE ENTITY'S ACCOUNTING PRACTICES

- 40. The auditor should communicate to those charged with governance the auditor's views about the qualitative aspects of the entity's accounting practices and financial**

¹¹ Requirements specific to the communication of misstatements resulting from fraud, or a suspected fraud, are set out in ISA 240 (Revised), "The Auditor's Responsibility to Consider Fraud ~~and Error~~ in an Audit of Financial Statements". In some jurisdictions the auditor may have other responsibilities to report certain misstatements to regulatory and enforcement authorities.

reporting that the auditor considers when forming an opinion on the financial statements.

41. In the course of the audit of the financial statements, the auditor considers the quality, as well as the acceptability, of the entity's accounting practices and financial reporting, including matters that have a significant impact on the relevance, reliability, comparability and understandability of the information provided by the financial statements (e.g. the consistency of the entity's accounting policies and their application, and the overall balance and clarity of the information contained in the financial statements). The auditor may conclude that some of these qualitative aspects affect whether the financial statements taken as a whole give a true and fair view (or present fairly, in all material respects) and, if so, discusses the implications for the auditor's report with those charged with governance; for example, the effects of bias in accounting estimates (see paragraphs 51 to 54).

Written Representations

- ~~35. The auditor should communicate other significant audit findings to those charged with governance, in accordance with ISA 260, "Communication of Audit Matters to Those Charged with Governance".~~

- ~~36. As described in paragraph 30 the auditor may identify matters that, although not considered to be misstatements, may otherwise be relevant to the auditor's report because of their nature. Where the auditor believes these other audit findings are significant they are discussed with those charged with governance.~~

- ~~42~~37. The auditor should obtain written representations from those who are responsible for approving and the issuing issuance of the financial statements to the users that they believe the effects of those uncorrected misstatements identified by the auditor during the audit are not material, either individually or in aggregate, to the financial statements taken as a whole. A summary of such misstatements should be included in or attached to the written representation.¹²

- ~~43~~38. Because those who are responsible for approving and the issuing issuance of the financial statements to the users ordinarily are responsible for ensuring that are responsible for adjusting the financial statements give a true and fair view (or are presented fairly, in all material respects) to correct misstatements, it is important that the auditor obtains a written representation from them that uncorrected misstatements are, in management's their opinion, immaterial, both individually and in the aggregate. Such representations are not a substitute for obtaining sufficient appropriate audit evidence. If management those who are responsible for approving and issuing the financial statements disagree do not accept that certain of the uncorrected financial statement misstatements aggregated by the auditor during the audit are misstatements (e.g. they may disagree with the auditor's judgments concerning financial statement amounts involving measurement uncertainty), the auditor asks them to provide a written representation that gives explanation of their reasons for not agreeing accepting that those items are misstatements.

¹² The summary need not include any misstatements that the auditor believes are "clearly trifling trivial".

Evaluating the Effect of Uncorrected Misstatements ~~on the Auditor's Report~~

~~4439.~~ **In forming the auditor's opinion on the financial statements, the auditor should evaluate whether the uncorrected misstatements that have been identified during the audit are material, individually or in aggregate, to the users of the financial statements. In making this evaluation, the auditor should consider the size and nature of the misstatements and the particular circumstances of their occurrence.**

~~40.~~ The auditor reviews misstatements in the context of the perceived importance of the related financial statement information to users. Consideration is given to the size and nature of the items. The circumstances related to misstatements may also be relevant to materiality considerations. For example:

- ~~• Whether the item is capable of objective determination or whether it involves a degree of subjectivity through estimation, allocation or uncertainty;~~
- ~~• Whether the misstatement affects compliance with regulatory requirements;~~
- ~~• Whether the misstatement affects compliance with debt covenants or other contractual requirements;~~
- ~~• Whether the item masks a change in earnings or other trends, especially in the context of general economic and industry conditions;~~
- ~~• The effect of the misstatement on ratios used to evaluate the entity's financial position, results of operations or cash flows;~~
- ~~• The effect of the misstatement on segment information (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);~~
- ~~• Whether the item has the effect of increasing management compensation, for example, by ensuring that the requirements for the award of bonuses or other incentives are satisfied;~~
- ~~• Whether the item changes a loss into a profit or vice versa;~~
- ~~• The pervasiveness of the misstatement (e.g. the misstatement might affect the presentation of numerous items in the financial statements);~~
- ~~• The effects of misclassifications (e.g. misclassification between operating and non-operating income or recurring and non-recurring income items; a misclassification between restricted and unrestricted resources in a not-for-profit organization; or a misclassification between balance sheet items that may not affect income);~~
- ~~• The significance of the misstatement relative to the auditor's understanding of users' needs and expectations. For example,:~~
 - ~~(i) The significance of earnings per share to public company investors; or~~
 - ~~(ii) The effect of misstatements of net income or loss when contrasted with expectations.~~
- ~~• The identity of the parties involved (e.g. whether external parties to the transaction are related to members of the entity's management).~~

~~4541.~~ Before ~~considering the aggregating aggregate the numerical amounts effect~~ of uncorrected misstatements, the auditor considers each misstatement separately:

- (a) ~~To evaluate its effect in~~ relation to individual classes of transactions, account balances and disclosures;
- (b) To evaluate whether, ~~it is appropriate if management to~~ offset certain ~~items misstatements, that is appropriate~~. For example, ~~it may be inappropriate the auditor considers whether it is appropriate to~~ offset a misstatement ~~relating to an estimated amount arising from a difference in judgment with against~~ a misstatement relating to an item capable of precise measurement, or ~~whether it is appropriate to~~ offset misstatements of items that are disclosed separately in the financial statements;
- (c) To evaluate the effect of a misstatement from prior periods and any cumulative effect becoming material in the current or subsequent reporting periods (see ~~also~~ paragraphs ~~4446 and 47-45~~).

The auditor also considers whether the misstatements reflect on the adequacy of the financial records maintained by the entity, or are indicative of internal control weaknesses, ~~and the implications for the assessment of audit risk and whether it has been reduced to an acceptably low level,~~ and ~~the implications thereof~~ for the auditor's reporting responsibilities.

~~42. Uncorrected misstatements are aggregated in a way that enables the auditor to assess the risks of material misstatement at the financial statement level, and at the level of individual classes of transactions, account balances and disclosures.~~

~~43. When the level of aggregate known and likely misstatements and differences of judgment approaches materiality or when misstatements can be traced to systemic breakdowns in internal control rather than isolated occurrences, the auditor considers whether further possible misstatements may exist that, in aggregate with identified misstatements, would be material. In most instances the amount of further possible misstatement cannot be precisely quantified and is evaluated by the auditor using professional judgment.~~

UNCORRECTED MISSTATEMENTS FROM PRIOR PERIODS

~~4464.~~ The auditor includes in ~~the aggregate aggregation of~~ misstatements the effect on the current period's financial statements of uncorrected prior-period misstatements.

~~4745.~~ When considering what is the appropriate treatment of misstatements related to prior periods, the auditor has regard to the requirements of the applicable financial reporting framework (e.g. whether accounting standards require or permit prior period misstatements to be corrected by way of restating the prior period or by correction in the current period). If management does not correct misstatements related to prior periods on a consistent basis (e.g. correcting some by way of prior period adjustment and others within the current period), or changes the method of correction from one period to another, the auditor considers the reasonableness of management's reasons for that, the effect on the financial statements and the implications for the auditor's report.

Evaluating the Overall Effect of Audit Findings on the Auditor's Report

48. The auditor should evaluate whether the financial statements taken as a whole give a true and fair view (or present fairly, in all material respects) in accordance with the applicable financial reporting framework. The auditor should consider whether the financial statements are free from material misstatement and also whether there are qualitative aspects of the entity's accounting practices and financial reporting that cause the financial statements taken as a whole not to give a true and fair view (or present fairly, in all material respects).
49. [Proposed revised] ISA 700, "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements" provides guidance for the auditor on forming the opinion on the financial statements. That guidance states that the auditor considers all audit evidence obtained and evaluates whether, based on that evidence, the auditor has obtained reasonable assurance that the financial statements taken as a whole are free from material misstatement. The auditor considers the sufficiency and appropriateness of audit evidence obtained, and evaluates the effects of the misstatements identified.
50. The guidance in [proposed revised] ISA 700 also states that the auditor considers, inter alia, whether, in the auditor's judgment, the accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate in the circumstances; and whether the financial statements reflect the underlying transactions and events in manner that fairly presents the financial information in accordance with the applicable financial reporting framework.

POSSIBLE MANAGEMENT BIAS

51. In matters involving the exercise of judgment, financial reporting frameworks often call for a quality of neutrality, that is freedom from bias, in financial statements. Management may have considerable latitude in exercising its judgment, for example in relation to accounting estimates and the selection and application of accounting policies.
52. When evaluating the overall effect of audit findings, the auditor considers whether management's judgments, when looked at together with the other audit findings, cause the financial statements taken as a whole not to give a true and fair view (or present fairly, in all material respects). This may be the situation even though, when considered individually, management's judgments are not considered to cause material misstatement of the related information.
53. For example, with respect to accounting estimates, management may have latitude in the selection of assumptions on which the estimate is to be based and, within the constraints imposed by the applicable financial reporting framework, may also have the ability to select the point within a range of possible outcomes at which an accounting estimate will lie. Notwithstanding that each accounting estimate may be considered reasonable when looked at in isolation, when looked at collectively, accounting estimates may be considered to be misstated when, for example:
- Accounting estimates consistently lie at one boundary of the reasonable range of possible outcomes. For example, management may select and apply assumptions based

on a desire to minimize the negative effect or maximize the positive effect of accounting estimates on reported earnings;

- Accounting estimates move from one consistent location within a range of possible outcomes to another in successive periods. For example, management may change from recognizing estimates of provisions from the mid point of the range to the boundary of the range.

54. When the auditor believes that there is bias in management's judgments they consider the implications for the auditor's report and discuss their views with those charged with governance (see paragraphs 40 and 41).

THE AUDITOR'S REPORT

5546. If the auditor ~~is not able to~~ concludes that the financial statements taken as a whole do not give a true and fair view (or present fairly, in all material respects), ~~uncorrected misstatements, individually and in aggregate, are not material,~~ the auditor should consider the appropriate modification to the auditor's report in accordance with [proposed] ISA 700701, "Modifications to tThe Independent Auditor's Report-on Financial Statements."

Intentional misstatements and earnings management

47. The auditor should adopt an attitude of professional skepticism to evaluate whether management has intentionally misstated certain items (possibly by amounts below the audit materiality levels) to "manage" reported earnings or trends and key financial indicators (e.g. intentional misstatements could be used by management as a means of achieving forecast results). Matters which suggest fraudulent financial reporting practice, and the auditor's response to them, are addressed in ISA 240.

Legal and Regulatory Reporting Responsibilities

5648. In addition to expressing an opinion on the entity's financial statements, ~~some countries~~ the auditor may have other legal or regulatory reporting responsibilities beyond providing an opinion on the entity's financial statements, for example, a responsibility to report if the entity has not maintained adequate financial records or systems of internal control. Where relevant, the auditor should consider the effect of identified misstatements ~~with regard~~ in relation to such reporting responsibilities.

57. Failure to record accurately items that would not otherwise be considered material may, in some instances, result in violations of those laws and regulations with contingent consequences for the entity (e.g. fines or withdrawal of operating licenses).

Documentation

5849. In addition to the other documentation requirements set out in paragraph 28 of this ISA, ~~t~~The auditor should document:

- (a) The materiality levels, including any changes thereto, used in risk ~~assessments~~ assessment procedures and determining the nature, timing and extent of the further audit procedures and in evaluating the results of the audit procedures, and the basis on which those levels were determined;
- (b) ~~An analysis~~ Summaries of corrected and unadjusted ~~uncorrected~~:
 - (i) Known misstatements;
 - (ii) Likely misstatements; and
 - (iii) Misstatements arising from differences in judgment.
- (c) The auditor's views about the qualitative aspects of the entity's accounting practices and financial reporting that the auditor communicates to those charged with governance, in accordance with paragraph 40, and the response, if any, of those charged with governance ~~Other matters which, although not considered to be misstatements, may otherwise be relevant to the auditor's report because of their nature. For example concerns relating to management bias;~~
- (d) The auditor's conclusion as to whether uncorrected misstatements do or do not cause the financial statements taken as a whole to be materially misstated, and the basis for that conclusion. ~~The conclusion, and basis thereof, as to whether uncorrected misstatements cause the financial statements to be materially misstated.~~

59. Misstatements are documented in a manner that allows the auditor to:

- (a) Separately consider the effects of known misstatements, likely misstatements and misstatements arising from differences in judgment on the financial statements;
- (b) Consider the effect of aggregate misstatements on the financial statements; and
- (c) Assess the effect of misstatements on particular groups of accounts, segment information, ratios, trends and compliance with legal, regulatory and contractual requirements (e.g. debt covenants).

Effective Date

~~5600~~. This ISA is effective for audits of financial statements for periods ending on or after [date].

Public Sector Perspective

This section to be considered by the Public Sector Committee

~~SUMMARY OF OTHER AUDIT FINDINGS~~

- ~~1. Possible breaches of law or regulations.~~
- ~~2. Transactions that appear unusual as to nature or amount.~~
- ~~3. Inadequate or inaccurate descriptions of an accounting policy.~~
- ~~4. Failure to maintain proper financial records.~~
- ~~5. Management bias.~~

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