

**MARKED FROM ED TEXT**

**PROPOSED INTERNATIONAL STANDARD ON AUDITING XXX  
EVALUATION OF MISSTATEMENTS IDENTIFIED DURING THE AUDIT**

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

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International Standard on Auditing (ISA) XXX, “Evaluation of Misstatements Identified During the Audit” 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.

## **Introduction**

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on evaluating misstatements identified during the audit of financial statements. ISA 320, “Materiality in Planning and Performing an Audit” establishes standards and provides guidance on the determination of materiality and its application in planning and performing an audit of financial statements.
2. The auditor should evaluate the effect of uncorrected misstatements<sup>1</sup> on the financial statements, and whether the financial statements as a whole are free of material misstatement.

## **Nature and Causes of Misstatements**

43. A misstatement is 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 or, in the auditor’s judgment, is otherwise necessary for the fair presentation of the financial statements. Misstatements can arise from error or fraud and may ~~consist of~~ result from:
  - (a) An inaccuracy in gathering or processing data from which the 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;~~
  - ~~(eb) An omission of an amount or disclosure that is required by the applicable financial reporting framework, or is otherwise needed for the fair presentation of the financial statements;~~
  - ~~(dc) An incorrect accounting estimate arising, for example, from an oversight overlooking or clear~~ misinterpretation of facts; and
  - ~~(ed) Differences between m~~Management’s ~~and the auditor’s~~ judgments concerning accounting estimates;<sup>2</sup> or the selection and application of accounting policies that the auditor considers unreasonable or inappropriate.
54. The term “error” refers to an unintentional misstatement in the financial statements. The term “fraud” refers to an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain

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<sup>1</sup> Uncorrected misstatements are misstatements that the auditor has accumulated during the audit and that management has not corrected.

<sup>2</sup> ~~The determination 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 ISA 540 (Revised), “The Audit of Accounting Estimates and Related Disclosures (Excluding Those Involving Fair Value Measurements and Disclosures).”~~

an unjust or illegal advantage. Two types of intentional misstatements are relevant to the auditor, that is, misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets. ~~These misstatements are addressed in ISA 240 (Revised), "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements."~~

### **Accumulation of Identified Misstatements**

**5. The auditor should accumulate misstatements identified during the audit, other than those that are clearly trivial.**

**6. "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. Further, whenever there is any uncertainty about whether one or more items are "clearly trivial," the auditor presumes that the matter is not "clearly trivial."**

**7. To assist the auditor in communicating misstatements accumulated during the audit to management and those charged with governance, it is useful to distinguish among factual misstatements, judgmental misstatements and projected misstatements.**

- Factual misstatements are misstatements about which there is no doubt.**
- Judgmental misstatements are 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.**
- Projected misstatements are misstatements that the auditor projects, based on an extrapolation from audit evidence obtained. For example, the amount obtained by projecting misstatements identified in an audit sample to the entire population from which the sample was drawn.**

### **Considerations as the Audit Progresses**

**258. The auditor should consider whether the overall audit strategy and audit plan need to be revised if-:**

**(a) ~~¶~~The nature of identified misstatements and the circumstances of their occurrence are indicative that other misstatements may exist that, when aggregated with identified misstatements, could be material-; or**

**(b) The aggregate of the misstatements accumulated during the audit approaches the materiality level, and the auditor considers that there is a greater than 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 possibly 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).

~~269.~~ The auditor cannot simply assume that a misstatement is 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. ~~In such circumstances the auditor evaluates whether the overall audit strategy and audit plan, and consequently the nature, timing and extent of further audit procedures, need to be reconsidered to reduce audit risk to an acceptably low level.~~

~~27.~~ ~~If the aggregate of the misstatements that the auditor has identified approaches the materiality level, the auditor should consider whether there is a greater than acceptably low level of risk that undetected misstatements, when taken with the aggregate identified misstatements, could exceed the materiality level and, if so, should reconsider the nature and extent of further audit procedures.~~

### **Communication and Correction of Misstatements ~~to Management~~**

~~2810.~~ **The auditor should accumulate all known and likely misstatements identified during the audit, other than those that the auditor believes are clearly trivial,<sup>3</sup> and communicate them all misstatements accumulated during the audit to the appropriate level of management on a timely basis.**

~~2911.~~ Timely communication of misstatements to the appropriate level of management is important as it enables management to evaluate whether the items are misstatements, or to inform the auditor if they disagree, and to take action as necessary. ~~The determination of which Ordinarily, the appropriate level of management is the appropriate one is based on such factors as the nature, size and frequency of the misstatement and which level of management can that has responsibility and authority to evaluate the misstatements and to~~ take the necessary action.

~~3012.~~ National laws may prevent the auditor from communicating certain misstatements 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. In such circumstances the auditor ordinarily seeks legal advice.

~~31.~~ ~~When communicating details of misstatements the auditor distinguishes between:~~

~~(a) — Known misstatements, separately identifying:~~

~~(i) — Misstatements of fact~~

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<sup>3</sup> This is not another expression for not material. Matters which are “clearly 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, nature or circumstances. Further, whenever there is any uncertainty about whether one or more items are “clearly trivial” (in accordance with this definition), the auditor presumes that the matter is not “clearly trivial.”

~~— These are specific misstatements identified during the audit including, for example, those arising from mistakes in gathering or processing data and the overlooking or misinterpretation of facts; and~~

~~(ii) Misstatements involving subjective decisions~~

~~— These arise from differences between management's and the auditor's judgments concerning accounting estimates (e.g., because an estimate included in the financial statements by management is outside of the reasonable range of outcomes the auditor has determined) or the selection and application of accounting policies that the auditor considers to give rise to misstatements; and~~

~~(b) Likely misstatements~~

~~— These are misstatements that the auditor considers likely to exist based on an extrapolation from audit evidence obtained, for example the amount obtained by projecting known misstatements identified in an audit sample to the entire population from which the sample was drawn.~~

~~3213. The auditor should request management to correct all **known** misstatements **accumulated during the audit, other than those that the auditor believes are clearly trivial. Where the auditor evaluates the amount of likely misstatement in a class of transactions, account balance or disclosure as material, either individually or in aggregate with other misstatements, the auditor should request management to examine the class of transactions, account balance or disclosure in order to identify and correct misstatements therein.** In the case of projected misstatements, it may often be necessary for management to examine the class of transactions, account balance or disclosure to identify and correct misstatements therein. After management has examined a class of transactions, account balance or disclosure and corrected misstatements that are found, the auditor performs further audit procedures to reevaluate the amount of projected misstatement.~~

~~33. After management has examined a class of transactions, account balance or disclosure and corrected misstatements that are found, the auditor performs further audit procedures to reevaluate the amount of likely misstatement. The auditor discusses with management the consequences for the auditor's report if management does not examine the class of transactions, account balance or disclosure to identify and correct misstatements found.~~

~~3414. If management refuses to correct some or all of the misstatements communicated to it by the auditor, or identified when management examined a class of transactions, account balance or disclosure, the auditor obtains an understanding of management's reasons for not making the corrections and takes that into account when considering the qualitative aspects of the entity's accounting practices (see paragraph 39) and the implications for evaluating the overall effect of audit findings on the auditor's report (see paragraph 42).~~

## Evaluating the Effect of Uncorrected Misstatements

~~3515. The auditor should evaluate whether uncorrected misstatements **that have been identified during the audit** are material, individually or in aggregate. In making this evaluation, the auditor should 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.**

**3616.** Before considering the aggregate effect of ~~identified~~ uncorrected misstatements, the auditor considers each misstatement separately to:

- (a) ~~To e~~Evaluate its effect ~~in relation to~~ on the relevant ~~individual~~ classes of transactions, account balances or disclosures, including whether the materiality levels for that particular ~~items of lesser amounts than the materiality level for the financial statements as a whole, determined in accordance with paragraph 17, have~~ class of transactions, account balance or disclosure, if applicable, has been exceeded;
- (b) ~~To e~~Evaluate whether, ~~in considering the effect of the individual misstatement on the financial statements as a whole,~~ it is appropriate to offset misstatements. ~~For example, it may be inappropriate to offset misstatements of items that are disclosed separately in the financial statements~~ 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 auditor considers the risk that further undetected misstatements may exist before concluding that offsetting such immaterial misstatements is appropriate,<sup>4</sup>
- (c) Evaluate the financial statement impact of classification misstatements. The determination of whether a classification misstatement is material requires the use of professional judgment and the evaluation of qualitative considerations, such a 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 evaluates that a classification misstatement, while exceeding materiality, is not considered qualitatively material.
- (e) ~~To evaluate the effect of misstatements related to prior periods.~~

17. The auditor also considers 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. The cumulative effective of immaterial uncorrected misstatements related to prior periods may have a material effect on the current period's financial statements. The auditor, therefore, considers both the adjustment(s) necessary to correct misstatements in the ending balance sheet, even if they arose in whole or part in prior periods, and the adjustment(s) necessary to correct misstatements affecting the current income statement.

**3718.** The circumstances related to some misstatements may cause the auditor to evaluate them as material, individually or when considered together with other ~~identified~~ misstatements

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<sup>4</sup> 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.

accumulated during the audit, even if they are ~~of a lower level than the auditor had determined to be material when establishing the overall audit strategy~~ 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;
- 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 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" establishes standards and provides guidance on 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.

**3819.** If the auditor believes that a misstatement is, or may be, the result of fraud, the auditor considers the implications of the misstatement in relation to other aspects of the audit as described in ISA 240 ~~(Revised)~~, “The Auditor’s Responsibility to Consider Fraud in an Audit of Financial Statements.” even if the effect of the misstatement is not material to the financial statements.

### Management Representations

**20. The auditor should obtain written representation from management that it believes the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements taken as a whole. A summary of such items should be included in or attached to the written representations.**

**21. Because management is responsible for adjusting the financial statements to correct material misstatements, it is important that the auditor obtain written representation from management that any uncorrected misstatements resulting from either fraud or error are, in management’s opinion, immaterial, both individually and in the aggregate. Such representations are not a substitute for obtaining sufficient appropriate audit evidence. In some circumstances, management may not believe that certain of the uncorrected financial statement misstatements aggregated by the auditor during the audit 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 Whether the Financial Statements as a Whole are Free of Material Misstatement**

**3922. The auditor should evaluate whether the financial statements as a whole are free of material misstatement. In making this evaluation, the auditor should consider both the results of the evaluation of the uncorrected misstatements ~~required in paragraph 35~~ and the qualitative aspects of the entity’s accounting practices. [Proposed] ISA 260 (Revised), “Communication of Audit Matters with Those Charged with Governance” provides guidance on the auditor’s communication of the qualitative aspects of an entity’s accounting practices.**

**4023.** 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 ~~preparing~~ 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 ~~that have been identified during the audit~~, cause the financial statements as a whole to be materially misstated. Indicators of a lack of neutrality ~~in management’s judgments~~ that the auditor takes into account when considering evaluating 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 ~~course of 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—~~(e.g., when management’s selection of accounting estimates appears to lack neutrality, including, for example, where estimates consistently lie at one end of the reasonable ranges of outcomes, or when management changes the relative location of an accounting estimate within the reasonable range of outcomes from period to period)—see proposed ISA 540 (Revised), “The Audit of Accounting Estimates and Related Disclosures (Excluding Those Involving Fair Value Measurements and Disclosures)” for further guidance.~~

24. [Proposed] 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 of material misstatement.

~~4425. If the auditor believes that the financial statements as a whole are materially misstated, the auditor should **discuss the matter with management and, where appropriate, request management to make the necessary corrections.** If management refuse to make the necessary corrections, the auditor considers the implications for effect thereof on the auditor’s report (see paragraph 42).~~

### Evaluating the Overall Effect of Audit Findings on the Auditor’s Report

~~4426. If the auditor concludes that, or is unable to conclude whether, the financial statements are materially misstated, the auditor should consider the **implications for effect thereof on the auditor’s report on the financial statements.**~~

~~4327. [Proposed] ISA ~~701~~705, “Modifications to the Opinion in the Independent Auditor’s Report,” provides guidance on circumstances when the independent auditor’s report should be modified and the form and the content of the modifications to the auditor’s report in those circumstances establishes standards and provides guidance on 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.~~

### Communications with Those Charged with Governance

~~4428. Standards and guidance regarding communications about uncorrected misstatements to those charged with governance are set out in [proposed] ISA 260 (Revised), “Communication of Audit Matters with Those Charged with governance.”~~

### Documentation

~~4529. The auditor should document:~~

- ~~(ba) **A summary of uncorrected misstatements, other than those that are clearly trivial, related to known and likely misstatements All misstatements accumulated during the audit, and whether they have been corrected by management; and**~~

- (eb) **The auditor's conclusion as to whether uncorrected misstatements, individually or in aggregate, ~~do or do not~~ cause the financial statements as a whole to be materially misstated, and the basis for that conclusion.**

**4630.** Misstatements are documented in a manner that allows the auditor to:

- (a) Separately consider the effects of: factual misstatements, judgmental misstatements and projected misstatements;
- ~~(i) Known misstatements, distinguishing between misstatements of fact and misstatements involving subjective decisions; and~~
- ~~(ii) Likely misstatements;~~
- (b) Consider the aggregate effect of uncorrected misstatements on the financial statements; and
- (c) Assess the effect of uncorrected misstatements on ~~particular significant~~ groups of accounts, segment information, key ratios, or trends, and compliance with legal, regulatory and contractual requirements (e.g., debt covenants).

## Effective Date

**4731.** This ISA is effective for audits of financial statements for periods beginning on or after [date].

## Public Sector Perspective

1. In the public sector, 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.
2. In evaluating the materiality of a misstatement, the public sector auditor ~~should~~ considers any legislation or regulation which may affect that evaluation.
- ~~2. In the public sector, issues such as public interest and ensuring effective legislative oversight should be 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.~~