



International Federation of Accountants

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Agenda Item

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Committee: IAASB
Meeting Location: New York
Meeting Date: May 22-26, 2006

Materiality and Misstatements

Objectives of Agenda Item

1. To approve proposed ISA 320 (Revised), “Materiality in the Identification and Evaluation of Misstatements” and proposed ISA 450, “Evaluation of Misstatements Identified during the Audit” as the “final ISAs under the existing drafting conventions.”
2. To note preliminary comments on the proposed clarity redrafts of the ISAs.

Task Force Members

3. The members of the Task Force are:

Denise Esdon (Chair)	IAASB member
Lyn Graham	US ASB member
Jon Grant	IAASB technical advisor
Diana Hillier	IAASB member
David Lindsell	UK APB member
Graham Pimlot	UK APB member
Roberto Tizzano	IAASB member

Activities since Last IAASB Discussions

4. The Task Force met on February 6-7 and held a telephone conference on April 18 to consider the comments received from the IAASB CAG and the IAASB.

Significant Comments – Proposed ISA 320 (Revised)

MANAGEMENT’S MATERIALITY

5. After discussion at the December meeting, the IAASB concluded that a number of paragraphs in the requirements and application material of ISA 315, “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement,” contain implicit references to management’s materiality and that it was not necessary to include an explicit reference in proposed ISA 320 or to amend ISA 315 to include such a reference.

MATERIALITY IN THE CONTEXT OF AN AUDIT

6. Some CAG representatives expressed the view that the auditor should use the definition of materiality in the applicable financial reporting framework to determine materiality for planning and performing the audit. Some CAG representatives also noted that, while the proposed revised ISA 320 described the concept of materiality, it did not formally define materiality. The IAASB noted that a formal definition of materiality would provide a “hook” for the discussions that follow.
7. Recognizing that the applicable financial reporting framework may not define materiality or may provide a definition that differs now or may differ at a later date from that in proposed ISA 320 (Revised) (that is, should such a definition be included), the Task Force concluded that the comments would be best addressed by describing the elements of materiality often discussed in financial reporting frameworks, and by indicating that, should such a discussion of materiality exist in the financial reporting framework, it provides a frame of reference to the auditor in determining materiality level or levels for the audit. If the applicable financial reporting framework, however, does not include a discussion of materiality, the elements described in proposed ISA 320 (Revised) provide the auditor with such a frame of reference. See paragraphs 4-6 of proposed ISA 320 (Revised).
8. The Task Force recommends that the explanation of materiality in the context of an audit follow the Introduction section of proposed ISA 320 (Revised and Redrafted). Although it may be argued that the Materiality in the Context of an Audit section is long (even longer than the Requirements section), the Task Force is of the view that this section is important and necessary for the requirements to be understood in that context.

USE OF BENCHMARKS IN DETERMINING MATERIALITY

9. A CAG representative expressed the view that the proposed ISA should not include examples of percentages that could be applied to chosen benchmarks. Another CAG representative noted that examples of percentages, if any, should be in the application material of the redrafted ISA. The Task Force is of the view that the guidance on benchmarks and percentages will enhance the consistent application of the proposed requirements. In December, the IAASB agreed that the examples should be retained. However, recognizing the concerns of respondents to the ED and of the CAG representatives, the IAASB agreed that the text should be amended to be less prescriptive, and the guidance should be in the application material of the redrafted ISA. The Task Force revised the text in line with the comments received. See paragraph 15 of proposed ISA 320 (Revised).

TOLERABLE ERROR

10. In the draft considered by the IAASB in December, the Task Force had expanded the guidance on tolerable error to explain the concept in general terms, without referring to the term “tolerable error.” The IAASB concluded that it was important that the concept remained in the proposed revised ISA 320; however, it did not need to be explained beyond what the Task Force had proposed. The IAASB agreed, however, that the need for further research in this area should be considered by the Steering Committee.
11. The Steering Committee considered the matter in March. The Steering Committee was of the view that it would be difficult to start a project to study the concept on its own without also

expanding the project scope to include consideration of the inter-relationship between tolerable error and materiality, which is at the heart of the problem. The Steering Committee agreed that the principle was clear in proposed ISA 320 (Revised) – that is, the auditor should use tolerable error to identify misstatements of lesser amounts than the materiality levels the auditor has established to determine, when aggregated, whether they could, in fact, result in a material misstatement of the financial statements. The level at which tolerable error should be established depends on a firm’s audit methodology and, in particular, the sampling approach adopted. It would be up to firms and practitioners to establish their own policies for determining appropriate tolerable error levels that would meet the spirit of this principle. It was difficult to see how, unless there was something flawed in the view that different sampling approaches rightly supported different approaches to tolerable error, what research could add; and this is particularly the case where the IAASB has not sought to support a specific way of arriving at what would be material. Accordingly, the Steering Committee agreed that a research project on tolerable error was not necessary

Significant Comments – Proposed ISA 450

MISSTATEMENTS

12. The IAASB asked the Task Force to reconsider the definition of misstatement, and the remainder of proposed ISA 450, to ensure that it was not limited to financial reporting frameworks designed to achieve fair presentation. The Task Force revised the definition of misstatement as suggested by the IAASB. See paragraph 3 of proposed ISA 450. It also reviewed the remainder of the proposed ISA to ensure that it applies to all financial reporting frameworks.
13. The Task Force was also asked to clarify the link between materiality determined for planning and performing the audit and materiality used to evaluate uncorrected misstatements. The split of the exposure draft into two documents might have created the impression that the auditor determines planning materiality and evaluation materiality. The link between “planning materiality” and “evaluation materiality” was strengthened. See paragraphs 7-8 of proposed ISA 320 (Revised) and paragraph 21-23 of proposed ISA 450.

ACCUMULATION OF IDENTIFIED MISSTATEMENTS

14. In relation to the categorization of misstatements, the IAASB agreed that it should be clarified that projected misstatements are based on projections from reliable samples. Paragraph 7 of proposed ISA 450 was amended to indicate that projected misstatements are 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.
15. The IAASB also asked the Task Force to reconsider the guidance that discusses management’s actions with regard to projected misstatements. Paragraph 10 was added to explain that it may be necessary for management to examine a 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 were found, the auditor performs further audit procedures to reevaluate the amount of misstatements. Since this applies to all misstatements, the guidance was not limited to projected misstatements.

16. In addition, paragraph 14 of proposed ISA 450 was expanded to explain that it is important for management to correct all misstatements accumulated during the audit because the cumulative effect of immaterial uncorrected misstatements may have a material effect on future periods' financial statements.

PRIOR PERIOD UNCORRECTED MISSTATEMENTS

17. The Task Force was asked to further consider the guidance on prior period uncorrected misstatements. The Task Force remains of the view that the IAASB cannot mandate one approach for the auditor to account for prior period uncorrected misstatements because of transitional provisions which could only be mandated by a regulator or equivalent authority. Proposed ISA 450, "Evaluation of Misstatements Identified during the Audit" requires the auditor to request management to correct all misstatements. The existence of prior period uncorrected misstatements should therefore diminish over time.
18. To provide for the current situation, the proposed guidance has been revised to explain that the cumulative effect of immaterial uncorrected misstatements related to prior periods may have a material effect on the current period's financial statements. Consequently, the auditor's consideration may take account of the effect of such misstatements on the ending balance sheet, or on the current period's income statement and balance sheet, or both. It is not possible to prescribe an approach; however, it is important that the auditor applies the selected approach consistently from period to period. See paragraph 26 of proposed ISA 450.

Material Presented

<p>Agenda Paper 9-A (Pages 1097-1104)</p>	<p>Proposed ISA 320 (Revised), “Materiality in the Identification and Evaluation of Misstatements” – CLEAN (CLOSE OFF DRAFT)</p>
<p>Agenda Paper 9-B (Pages 1105-1114)</p>	<p>Proposed ISA 450, “Evaluation of Misstatements Identified during the Audit” – CLEAN (CLOSE OFF DRAFT)</p>
<p>Agenda Paper 9-C (Pages 1115-1124)</p>	<p>Proposed ISA 320 (Revised), “Materiality in the Identification and Evaluation of Misstatements” – MARK-UP (Based on close off draft discussed at December 2005 IAASB meeting)</p>
<p>Agenda Paper 9-D (Pages 1125-1134)</p>	<p>Proposed ISA 450, “Evaluation of Misstatements Identified during the Audit” – MARK-UP (Based on close off draft discussed at December 2005 IAASB meeting)</p>
<p>Agenda Paper 9-E (Pages 1135-1142)</p>	<p>Proposed ISA 320 (Revised and Redrafted), “Materiality in the Identification and Evaluation of Misstatements”</p>
<p>Agenda Paper 9-F (Pages 1143-1152)</p>	<p>Proposed ISA 450 (Redrafted), “Evaluation of Misstatements Identified during the Audit”</p>
<p>Agenda Paper 9-G (Pages 1153-1162)</p>	<p>ISA 320: Mapping Document</p>
<p>Agenda Paper 9-H (Pages 1163-1174)</p>	<p>ISA 450: Mapping Document</p>

AGENDA PAPERS X-A AND X-B WILL BE USED FOR PURPOSES OF THE DISCUSSION AT THE MAY IAASB MEETING.

Action Requested

19. The IAASB is asked to approve proposed ISA 320 (Revised) and proposed ISA 450 as the “final ISAs under the existing drafting conventions.” Time permitting, the IAASB is also asked to note preliminary comments on the proposed clarity redrafts of the ISAs.

The comment letters received on the exposure draft are available from:

<http://www.ifac.org/Guidance/EXD-Comments.php?EDID=0038&Group=All+Responses>

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