

Extracts from working draft of proposed ISA 320 “Materiality in the Identification and Evaluation of Misstatements”

Purpose

These extracts from the latest working draft of ISA 320 being considered by the Materiality Task Force are presented solely to demonstrate how some of the ideas and concepts discussed in ISA 540 either originate from, or are further developed in, ISA 320.

MISSTATEMENTS (SEE PARAGRAPH 69 OF ISA 540)

9. 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 estimated by the auditor that most likely exist based on audit evidence obtained. For example the projected effect of known misstatements identified in audit samples.

(c) Misstatements arising from 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 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 possible outcomes the auditor has determined to be reasonable; or, where there is a choice of accounting policies, the auditor considers the particular policy selected and applied by the entity to be inappropriate).

MATERIALITY FOR THE FINANCIAL STATEMENTS AS A WHOLE

12. **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.**

14. 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.

15. Materiality is determined regardless of the degree of inherent uncertainty associated with the measurement of particular items. For example, the existence of high degrees of uncertainty

in relation to the measurement of very large provisions (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) does not mean that the auditor determines that the materiality level for the financial statements taken as a whole should be correspondingly high.

ACCEPTABLE MISSTATEMENTS FOR CLASSES OF TRANSACTIONS, ACCOUNT BALANCES AND DISCLOSURES (SEE PARAGRAPH 78 AND APPENDIX 2 OF ISA 540)

21. ISA 315 requires the auditor to 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, the auditor allows for the affect of the aggregation of the risks of misstatement in different classes of transactions, account balances and disclosures, so that the combined risk of material misstatement at the assertion level is not greater than the risk of material misstatement at the financial statement level. To make this allowance the auditor uses professional judgment to determine levels of acceptable misstatement for classes of transactions, account balances and disclosures. The level of acceptable misstatement for a particular class of transaction, account balance or disclosure cannot be higher than the materiality level the auditor has determined for the financial statements taken as a whole and ordinarily is lower.
22. Similarly, when determining the nature, timing and extent of further audit procedures, the auditor allows for the affect of the aggregation of misstatements and for the possibility of misstatements that are not detected by the audit procedures. To make this allowance, the auditor uses professional judgment to establish levels of tolerable error¹ that the auditor is willing to accept in classes of transactions, account balances and disclosures.
23. The level of tolerable error 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 and ordinarily is lower. The level of tolerable error may be influenced by factors such as the auditor's experience of the results of previous audits for the client and, for the current audit, the auditor's professional judgment of the likelihood of errors in the particular class of transaction, account balance or disclosure.

EVALUATION OF UNCORRECTED MISSTATEMENTS (SEE PARAGRAPH 69 OF ISA 540)

46. **The auditor should evaluate whether the 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 and the particular circumstances of their occurrence.**

POSSIBLE MANAGEMENT BIAS (SEE PARAGRAPHS 75 TO 77 OF ISA 540)

54. 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 has considerable latitude in exercising its judgment, for example in relation to accounting estimates and the selection and application of accounting policies.

¹ "Tolerable error" is defined in ISA 530, "Audit Sampling and Other Selective Testing Procedures" as "the maximum error in a population that the auditor is willing to accept."

55. When evaluating the overall effect of audit findings, the auditor considers whether management's judgments, when looked at collectively 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. When the auditor believes that there is bias in management's judgments they discuss their views with those charged with governance (see paragraphs 42-43).
56. For example, with respect to accounting estimates, management has latitude for deciding about the appropriateness of assumptions and, within the constraints imposed by the accounting framework, it also has the ability to choose where an accounting estimate should lie within a range of possible outcomes. Notwithstanding that each accounting estimate may be considered reasonable when looked at in isolation, when looked at collectively they 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 when management consistently uses biased assumptions with respect to a number of accounting estimates;
 - 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 assets from the mid point of the range to the top end of the range.

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