

MARK-UP

**PROPOSED INTERNATIONAL STANDARD ON AUDITING 320 (REVISED)
MATERIALITY IN THE IDENTIFICATION AND EVALUATION OF
MISSTATEMENTS**

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International Standard on Auditing (ISA) 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.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on materiality, ~~including its relationship with audit risk~~ and how it is used in the identification and evaluation of misstatements when performing an audit of ~~a complete set of general purpose~~ financial statements¹. The guidance in the ISA is to be adapted for audits of historical financial information other than financial statements.
2. **The auditor should consider materiality when planning and performing the audit to reduce audit risk to an acceptably low level that is consistent with the objective of an audit.**
3. ISA 200, “Objective and General Principles Governing an Audit of Financial Statements,” requires the auditor to plan and perform the audit to reduce audit risk to an acceptably low level that is consistent with the objective of an audit. Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risk of material misstatement of the financial statements and the risk that the auditor will not detect such misstatement. ISA 315, “Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement,” 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. ISA 330, “The Auditor’s Procedures in Response to Assessed Risks,” requires the auditor to design and perform further audit procedures in response to assessed risks. In order to do so, the auditor considers materiality:
 - (a) 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 uncorrected misstatements on the auditor’s report.

Nature and Causes of Misstatements

4. A misstatement causes the financial statements to be not in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud and 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, or is otherwise needed for the fair presentation of the financial statements ~~to give a true and fair view or present fairly in all material respects;~~

¹ ~~Much of the guidance in this ISA can be adapted for audits of financial information other than an audit of a complete set of general purpose financial statements, such as special purpose engagements (ISA 800, “The Auditor’s Report on Special Purpose Audit Engagements”). Relevant ISAs provide additional guidance to the extent that it is necessary in such other engagements.~~

- (d) An incorrect accounting estimate arising, for example, from an oversight or misinterpretation of facts; and
 - (e) Differences between management's and the auditor's judgments concerning accounting estimates,¹ or the selection and application of accounting policies, that the auditor considers inappropriate.
5. 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 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, "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements".

Materiality in the Context of an Audit

6. ~~The auditor's judgment as to matters that are considered to be material in the context of an audit is based on a consideration of the nature of the intended users of the financial statements and an assessment of the matters that could influence their economic decisions.~~

Materiality can be defined in the following terms:

"Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor."²

7. If the applicable financial reporting framework uses a different definition of materiality, the auditor considers whether that definition includes other factors that are relevant to the auditor's determination of materiality in the context of the audit.

USERS

8. The auditor's judgment as to matters that are material to users of financial statements is based on consideration of the needs of:

- The intended users of the auditor's report; and
- Other users, if any, to whom the auditor has a legal responsibility³.

In an audit of general purpose financial statements, the auditor forms a judgment
~~For the purpose of determining materiality in the audit of general purpose financial statements, the auditor forms a judgment~~

¹ 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 revised] ISA 540, "The Audit of Accounting Estimates and Related Disclosures (Excluding Those Involving Fair Value Measurements and Disclosures)."

² As defined in International Accounting Standard (IAS) 1, "Presentation of Financial Statements". In the ISAs, misstatements are considered to include omissions.

³ Whether the auditor has a legal responsibility will depend on the circumstances of each case and the relevant jurisdiction.

~~as to the effect of misstatements on the economic decisions of the intended users for whom the auditor prepares the auditor's report.~~ The auditor considers the needs of ~~those intended~~² these users as a group; the auditor does not consider the possible effect of misstatements on specific individual users, which may vary widely². The International Accounting Standards Board's "Framework for the Preparation and Presentation of Financial Statements" (the IASB's Framework) indicates that, for a profit oriented entity, as investors are providers of risk capital to the enterprise, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy. In the audit of such entities, therefore, the collective needs of investors as a group is an appropriate frame of reference when determining materiality.

9. When determining materiality in audits of financial statements or other historical financial information prepared for a special purpose, the auditor considers the needs of specific users in the context of the objective of the engagement.

910. The evaluation of whether a misstatement could influence economic decisions of users, and so be material, involves consideration of the characteristics of those users. Users are assumed to~~be assumed to~~:

- (a) Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence;
- (b) Understand that financial statements are prepared and audited to levels of materiality and 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) Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and
- (d) Make reasonable economic decisions on the basis of that information.

The determination of materiality, therefore, takes into account how users with such characteristics could reasonably be expected to be influenced in making economic decisions.

Determining Materiality for the Financial Statements as a Whole

110. The auditor should determine a materiality level for the financial statements as a whole for the purpose of:

- (a) **Determining the extent and nature of risk assessment procedures;**
- (b) **Identifying and assessing the risks of material misstatement; and**
- (c) **Determining the nature, timing and extent of further audit procedures.**

12. The auditor determines a materiality level for the financial statements as a whole when establishing the overall audit strategy for the audit (see ISA 300, "Planning and Audit of Financial Statements")³. Determining a materiality level for the financial statements as a

² ~~When determining materiality in audits of financial statements prepared in accordance with a financial reporting framework designed for a special purpose, the auditor forms this judgment in the context of the auditor's understanding of the needs of the specific users.~~

³ ~~The auditor reconsiders this materiality level if necessary as the audit progresses (see paragraph 22).~~

whole helps to guide the auditor's judgments in identifying and assessing the risks of material misstatements and in planning the nature, timing and extent of further audit procedures. This materiality level does not, however, establish a threshold below which identified misstatements are always considered to be immaterial when evaluating those misstatements and their effect on the auditor's ~~opinion report~~. As discussed in paragraph 2736, the circumstances related to some identified misstatements may cause the auditor to evaluate them as material even if they are below the materiality level determined ~~for the purpose of planning the audit~~ when establishing the overall audit strategy.

USE OF PERCENTAGES OF BENCHMARKS

132. The determination of what is material is a matter of professional judgment. The auditor often applies a percentage to a chosen benchmark as a step in determining materiality for the financial statements ~~taken~~ as a whole. When identifying an appropriate benchmark, the auditor has regard to factors such as:

- The elements of the financial statements (e.g. assets, liabilities, equity, income and expenses) and the financial statement measures defined in the applicable financial reporting framework (e.g. financial ~~position~~ position-performance, financial performance position and cash flows), or other specific requirements in the 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 profit from continuing operations. Profit from continuing operations may be a suitable benchmark for profit oriented entities but 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 entity 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. For asset based entities, an appropriate benchmark might be net assets.

143. ~~While in practice there are ranges of possible percentages to be considered,~~ Illustrative examples of percentages applied to benchmarks that might be considered appropriate include:

- For a profit oriented listed entity, five percent of profit ~~after~~ before tax from continuing operations, or one half percent of total revenues;
- For a profit oriented owner managed entity, an amount of ten percent of profit before tax and management remuneration, or two percent of current assets or owners' equity;
- For a not-for-profit entity, one half percent of total expenses or total revenues;
- For an entity in the mutual fund industry, one half percent of net asset value.

The auditor may consider higher or lower percentages than those illustrated above to be appropriate. The benchmark selected and the percentage applied reflect, in the auditor's professional judgment, the measures that users are most likely to consider important.

154. When determining materiality, 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. For example, when the auditor usually determines materiality for a particular entity based on a percentage of profit, circumstances that give rise to an exceptional decrease or increase in profit may lead the auditor to conclude that materiality is more appropriately determined using an annualized profit figure based on past results, ~~or a different benchmark altogether such as total revenues.~~
165. Materiality is determined without regard to the degree of inherent uncertainty associated with the measurement of particular items. For example, the fact that the financial statements include very large provisions with a high degree of estimation uncertainty (e.g. provisions 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 cause the auditor to determine the materiality level for the financial statements to be higher than for financial statements that do not include such inherent estimation uncertainties.
- ~~16. The auditor ordinarily communicates the materiality level determined for the financial statements to those charged with governance in accordance with the requirements of ISA 260, "Communication of Audit Matters With Those Charged With Governance."~~

Materiality for Particular Items of Lesser Amounts Than the Materiality Level Determined for the Financial Statements as a Whole

17. **When establishing the overall strategy for the audit, the auditor should consider whether, in the specific circumstances of the entity, misstatements of particular items of lesser amounts than the materiality level determined for the financial statements as a whole, if any, could, in the auditor's judgment, reasonably be expected to influence economic decisions of users taken on the basis of the financial statements.** Any such amounts determined represent lower materiality levels to be considered in relation to the particular items in the financial statements.
18. In making this judgment, 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);
 - 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).

19. 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 as a whole, if any, ~~would could~~ reasonably ~~influence economic decisions of~~ be considered material by the users ~~taken on the basis~~ of the financial statements.

Tolerable Error

- ~~20. In order to design audit procedures to respond to assessed risks of material misstatement, the auditor considers the risk of material misstatement at two levels:~~
- ~~(a) The financial statement level; and~~
 - ~~(b) The assertion level in relation to classes of transactions, account balances and disclosures.~~
- ~~204.~~ When assessing the risks of material misstatements and designing and performing further audit procedures to respond to the assessed risks, the auditor allows for the possibility that some misstatements, of lesser amounts than the materiality level, could, in the aggregate, result in a material misstatement of the financial statements. To do so, the auditor uses professional judgment to determine levels of tolerable error⁴, ~~which are amounts lower than materiality~~, for classes of transactions, account balances and disclosures. Such amounts of tolerable error are lower than the materiality level.

Considerations as the Audit Progresses

- ~~212.~~ **The auditor should revise the materiality levels in the event of becoming aware of information during the audit that would have caused different levels to have been determined initially.**
- ~~223.~~ The auditor's determination of materiality for the financial statements as a whole and for particular items at the time of establishing the overall audit strategy 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 may have based materiality on the anticipated period end financial results; if actual financial results are substantially different, the determination of materiality may also change.
- ~~234.~~ If the auditor concludes that, ~~based on new information~~, a lower materiality level than that initially determined is appropriate, the auditor reconsiders the related levels of tolerable error and appropriateness of the nature, timing and extent of audit procedures.

~~Evaluation of Identified Misstatements~~

- ~~245. As misstatements are identified during the course of the audit, the auditor should evaluate whether those misstatements are material, individually and in aggregate with other misstatements that have already been identified. The auditor should consider~~

⁴ "Tolerable error" is the maximum error in a population (e.g. the class of transactions or account balance) that the auditor is willing to accept. ~~ISA 530, "Audit Sampling and Other Selective Testing Procedures," for example, explains that tolerable error is one of the factors influencing sample size for substantive procedures.~~

~~whether the overall audit strategy and audit plan need to be revised if auditor should also consider the nature of and circumstances of identified misstatements and the circumstances of their occurrence are indicative and evaluate whether there is any indication based on their nature and circumstances~~ that other misstatements may exist that, when aggregated with identified misstatements, could be material ~~and, if so, the auditor should consider whether the overall audit strategy and audit plan need to be revised.~~

256. The auditor cannot 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. The auditor also considers whether misstatements reflect on the adequacy of the financial records maintained by the entity, or are indicative of internal control weaknesses, and the implications thereof, if any, for the auditor's reporting responsibilities, ~~if any~~.

26. If the aggregate of the misstatements that the auditor has identified approaches the materiality level, the auditor considers whether it is likely that undetected misstatements, when taken with the aggregate identified misstatements, could exceed the materiality level and, if so, reconsiders the nature and extent of further audit procedures.

Communication of Misstatements to Management

279. The auditor should communicate all known and likely misstatements identified during the audit, other than those that the auditor believes are clearly trivial,⁵ to the appropriate level of management on a timely basis.

2830. 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. 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.

2934. 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.

⁵ 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."

3032. When communicating details of misstatements, ~~and evaluating their effect~~, the auditor distinguishes between:

(a) Known misstatements, separately identifying:

(i) Misstatements of fact

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; 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 ~~reasonably possible~~ outcomes the auditor has determined), or the selection and application of accounting policies, that the auditor considers to be 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.

313. The auditor should ~~encourage~~ request management to correct all known misstatements, 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. Where appropriate, the auditor also requests management to take action to reduce the estimated amount of likely misstatements.

324. ~~Where the auditor estimates the amount of likely misstatement in a class of transactions, account balance or disclosure to be 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 recheck the class of transactions, account balance or disclosure and, if possible, identify and correct misstatements found. When~~ After management performs has rechecked ~~examined a class of transactions, account balance or disclosure and corrects~~ corrected misstatements that are found, the auditor ~~then~~ performs further audit procedures to reevaluate the level amount of likely misstatements ~~s in the class of transactions, account balance or disclosure.~~ 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.

335. 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). ~~The auditor communicates details of~~

~~misstatements that management declines to correct to those charged with governance in accordance with the requirements of ISA 260, “Communication of Audit Matters With Those Charged With Governance.”~~

Evaluating the Effect of Uncorrected Misstatements

~~346. In forming the opinion as to whether the financial statements give a true and fair view, or are presented fairly in all material respects, in accordance with the applicable financial reporting framework, (t~~he 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.

35. Before considering the aggregate effect of identified uncorrected misstatements, the auditor considers each misstatement separately:

- (a) To evaluate its effect in relation to the relevant individual classes of transactions, account balances or disclosures;
- (b) To 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;
- (c) To evaluate the effect of misstatements related to prior periods.

~~3627.~~ The circumstances related to some misstatements may cause the auditor to evaluate them as material, individually or when considered together with other identified misstatements, even if they are of a lower level than the auditor had determined to be material when establishing the overall audit strategy ~~and audit plan~~. Circumstances that may affect the evaluation include ~~whether~~ 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 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 entity; 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;
- 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 circumstances listed above are only examples; not all of these circumstances 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.

3728. If the auditor believes that a misstatement is, or may be, the result of fraud then, even if the effect of the misstatement is not material to the financial statements, the auditor considers the implications of the misstatement in relation to other aspects of the audit as described in ISA 240, ~~"The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements"~~.

38. In evaluating whether the financial statements as a whole are free of material misstatement, the auditor also considers whether information obtained during the audit indicates that qualitative aspects of the entity's accounting practices have resulted in a material misstatement in the financial statements.

39. In preparing the financial statements, there are a number of judgments management makes in relation to the amounts and disclosures in those financial statements. During the audit, the auditor is alert for the possibility that management's judgments may be biased and that the cumulative effect of such a lack of neutrality, together with uncorrected misstatements that have been identified during the audit, may 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 whether the financial statements as a whole are materially misstated include:

- The selective correction of misstatements brought to management's attention during the course of the audit (e.g. the correction of misstatements with the effect of increasing reported earnings, but not the correction of 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 the auditor has determined, or when management changes the relative location of an accounting estimate within the reasonable range of outcomes from period to period) – See [proposed revised] ISA 540, “The Audit of Accounting Estimates and Related Disclosures (Excluding Those Involving Fair Value Measurements and Disclosures)” for further guidance.

- ~~37. [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. It 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 are free from material misstatement. That evaluation includes considering not only the sufficiency and appropriateness of audit evidence obtained, but also the effects of the misstatements identified.~~
- ~~38. Before considering the aggregate effect of uncorrected misstatements, the auditor considers each uncorrected misstatement separately:~~
- ~~(a) To evaluate its effect in relation to the relevant individual classes of transactions, account balances or disclosures;~~
 - ~~(b) To 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;~~
 - ~~(c) To evaluate the effect of a misstatement from prior periods and any cumulative effect becoming material in the current or subsequent reporting periods.~~
- ~~39. 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).~~
- ~~40. In evaluating whether the financial statements as a whole are free of material misstatement, the auditor considers the effect of the aggregation of uncorrected misstatements and management bias, if any, on the fair presentation of the financial statements.~~
- ~~Certain matters when looked at in isolation may not appear to result in a material misstatement but, when considered together with the uncorrected misstatements, may collectively cause the financial statements as a whole to be materially misstated. For example, if there are a number of biased accounting estimates that fall at the ends of ranges of reasonably and equally possible outcomes there is a risk that those accounting estimates, when looked at collectively with uncorrected misstatements, result in material misstatement of the financial statements, notwithstanding that each accounting estimate is considered reasonable when looked at individually (e.g. the combined effect on reported earnings of uncorrected misstatements and bias may be material).~~
- ~~41. ISA 540, “The Audit of Accounting Estimates and Related Disclosures (Excluding Those Involving Fair Value Measurements and Disclosures),” requires that the auditor evaluate whether there is any audit evidence indicating bias in the making of accounting estimates and, where there is such evidence, quantify the bias. Management bias with respect to accounting estimates arises in those circumstances where the applicable financial reporting~~

~~framework does not specify which point within a range of reasonably and equally possible outcomes is recognized and management selects an outcome which is not neutral. With respect to a range of reasonably and equally possible outcomes there is a rebuttable presumption that the mid point of the range is free from bias and therefore neutral. ISA 540 provides examples of indicators of bias and its quantification.~~

~~42. Possible management bias is one of the qualitative aspects of the entity's accounting practices that the auditor communicates to those charged with governance in accordance with ISA 260.~~

EVALUATING THE OVERALL EFFECT OF AUDIT FINDINGS ON THE AUDITOR'S REPORT

~~403. If the auditor **confirms concludes** that, or is unable to conclude whether, the financial statements are materially misstated, the auditor should consider the implications for the auditor's **opinion-report** on the financial statements.~~

~~414. [Proposed] ISA 701, "Modifications to 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.~~

Communications With Those Charged With Governance

~~42. Standards and guidance in respect of communications about materiality and misstatements to those charged with governance are set out in [proposed revised] ISA 260, "Communication of Audit Matters With Those Charged With governance."~~

Documentation

~~4345. The auditor should document:~~

- ~~(a) The levels of materiality **and tolerable error**, including any changes thereto, used in risk assessment procedures and **in** 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) Summaries of corrected and uncorrected misstatements related to known and likely misstatements; and~~
- ~~(c) The auditor's conclusion as to whether uncorrected misstatements individually or in aggregate, do or do not cause the financial statements to be materially misstated, and the basis for that conclusion.~~

~~4446. Misstatements are documented in a manner that allows the auditor to:~~

- ~~(a) Separately consider the effects of:

 - ~~(i) Known misstatements, distinguishing between misstatements of fact and misstatements involving subjective decisions; and~~
 - ~~(ii) Likely misstatements;~~~~
- ~~(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

4547. This ISA is effective for audits of financial statements for periods ~~ending~~commencing on or after [date].

Public Sector Perspective

1. *In evaluating whether a misstatement is material, the public sector auditor should consider any legislation or regulation which may impact 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.*

Appendix**Conforming Changes to Other ISAs****ISA 260 “Communication of Audit Matters with Those Charged with Governance”**

~~11a. The auditor should inform those charged with governance of those uncorrected misstatements aggregated by the auditor during the audit that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole.~~

~~11b. The uncorrected misstatements communicated to those charged with governance need not include the misstatements below a designated amount.~~

Communication of Materiality

~~11a. The auditor should communicate to those charged with governance the materiality level the auditor determined for the financial statements unless the auditor believes it probable that such communication would influence management’s approach to the preparation of the financial statements.~~

~~11b. 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. 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. The auditor also makes clear to those charged with governance that, due to the inherent limitations of an audit, there may be misstatements that the audit will not detect.~~

~~11c. The auditor does not communicate to those charged with governance, or to management, the materiality level for the financial statements if the auditor believes that such communication might, for example, result in management being less attentive to the detection and correction of misstatements.~~

Communication of Misstatements

~~11d. The auditor should communicate misstatements identified by the auditor during the audit that management declines to correct, other than those that the auditor believes are clearly trivial, to those charged with governance, unless they are the same persons as management (as may be the case in smaller entities). The auditor should also consider whether the auditor has a responsibility to report certain misstatements to regulatory and enforcement authorities.⁴~~

~~11e. In communications with those charged with governance, the auditor explains why the auditor considers misstatements to be material. As described in ISA 320, “Materiality in the Identification and Evaluation of Misstatements,” 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 as a whole when planning the audit. The circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are of a lesser amount.~~

~~11f. 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.~~

~~11g. 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.~~

~~11h. The auditor considers whether misstatements that management has previously corrected, 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 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

⁴ 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 in an Audit of Financial Statements.” In some jurisdictions the auditor may have other responsibilities to report certain misstatements to regulatory and enforcement authorities.

~~11i. 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 reporting that the auditor considers when forming an opinion on the financial statements.~~

~~11j. 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 are prepared, all material respects, in accordance with the applicable financial reporting framework 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.~~

ISA 580 "Management Representations"

5a. The auditor should obtain written representations from management that:

~~(a) It acknowledges its responsibility for the design and implementation of internal control to prevent and detect error;; and~~

~~(b) It believes the effects of those uncorrected misstatements aggregated by the auditor during the audit are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of such items should be included in or attached to the written representations.~~

~~5b. The auditor should obtain written representations from those charged with governance that they believe the effects of those uncorrected misstatements identified by the auditor during the audit are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of such items should be included in or attached to the written representations⁵.~~

~~5c. Because those charged with governance ordinarily are accountable for ensuring that the entity achieves its objectives, financial reporting, and reporting to interested parties, it is important that the auditor obtains a written representation from them that uncorrected misstatements are, in their opinion, immaterial, both individually and in the aggregate. If those charged with governance do not accept that certain of the uncorrected misstatements identified 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 explanation of their reasons for not accepting that those items are misstatements.~~

⁵ ~~The summary need not include any misstatements that the auditor believes are "clearly trivial".~~

~~Proposed Conforming Changes to Proposed IAPS, “The Audit of Group Financial Statements”~~

~~Materiality~~

~~28. ISA 320, “Audit Materiality in the Identification and Evaluation of Misstatements” contains standards and guidance on materiality and its relationship with audit risk and the evaluation of misstatements. The group auditor establishes a group materiality level when establishing the overall audit strategy for the to evaluate the effect of misstatements of the components’ financial information and the consolidation on the group financial statements. The group materiality level is based on the group financial statements.~~

~~29. The group auditor also establishes group planning materiality to determine the nature, timing and extent of audit procedures to be performed on the group financial statements. Group planning materiality is also based on the group financial statements.~~

~~30. The group auditor uses group planning materiality to determine planning materiality to be used when performing work on the components’ financial information. The group auditor’s determination of planning materiality for components is a matter of professional judgment and may be impacted by factors such as the individual financial significance of a component and whether a component has been identified at group level as likely to include significant risks of material misstatement of the group financial statements. Planning materiality for a component does not exceed, and in practice sometimes is lower than, group planning materiality.~~

~~29. The group auditor also determines the materiality levels to be used for group reporting purposes when performing work on the components’ financial information. The group auditor’s determination of materiality levels for individual components is a matter of professional judgment and may be affected by factors such as:~~

- ~~• The structure of the group (for example the number of components and their individual financial significance);~~

- ~~• Whether a component has been identified at group level as likely to include significant risks of material misstatement of the group financial statements; and~~

- ~~• Group wide controls (which may affect the auditor’s evaluation of the expected level of misstatements in components);~~

~~For group reporting purposes, to allow for the aggregation of identified misstatements and the possible existence of undetected misstatements, the materiality level of a component is lower than group materiality.~~

~~30. When planning audit procedures for a component for group reporting purposes, the component auditor ordinarily establishes levels of tolerable error lower than the component materiality level to allow for the possibility that some misstatements, of lesser amounts than the materiality level, could be material in the aggregate.~~

~~31. Where the work on a component will be performed by a related auditor or other auditor, the group auditor communicates the planning materiality level determined by the group auditor for the component. The group auditor also communicates a threshold below which misstatements are regarded as clearly inconsequential and, as a result, need not be communicated to the group auditor.~~

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