

Proposed International Standard on Auditing 320 (Revised)

Materiality in the Identification and Evaluation of Misstatements



International Federation
of Accountants

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REQUEST FOR COMMENTS

This exposure draft of the International Auditing and Assurance Standards Board (IAASB) was approved for publication in December 2004. The proposed revised International Standard on Auditing (ISA) may be modified in light of comments received before being issued in final form.

Comments should be submitted so as to be received by **April 30, 2005**, preferably by e-mail or on computer disk, or in writing. All comments will be considered a matter for the public record. Comments should be addressed to:

Technical Director
International Auditing and Assurance Standards Board
545 Fifth Avenue, 14th Floor
New York, New York 10017 USA

Email responses should be sent to: Edcomments@ifac.org

The approved text of this exposure draft is published in the English language. In order to achieve maximum exposure and feedback, the International Federation of Accountants encourages the reproduction of this publication in any format.

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EXPLANATORY MEMORANDUM

Introduction

This memorandum provides some background to, and an explanation of, the proposed revised International Standard on Auditing (ISA) 320, under a new title of “Materiality in the Identification and Evaluation of Misstatements,” approved for exposure by the International Auditing and Assurance Standards Board (IAASB) in December 2004.

Background

Since the issuance of ISA 320, “Audit Materiality,” several national standard setters have revised and expanded their existing standards and guidance. There is increased recognition in particular of the need for greater consideration not only of the size of an item, but also of its nature and of the circumstances of the entity when determining materiality and evaluating misstatements. Work undertaken by the United Kingdom’s Auditing Practices Board (UK APB) on aggressive earnings management also highlighted audit materiality as an important area. In light of this, the IAASB approved a project for a comprehensive revision of ISA 320 and a joint Task Force was established comprising members of the IAASB and the UK APB.

Significant Proposals

The Definition of Materiality

The proposed revised ISA 320 includes a definition of materiality that makes clear that materiality depends on the size and nature of an item judged in the surrounding circumstances. The definition is the same as that in International Accounting Standard (IAS) 1, “Presentation of Financial Statements,” issued by the International Accounting Standards Board (IASB). The proposed revised ISA 320 also makes clear that if the applicable financial reporting framework provides a different definition of materiality, the auditor uses that definition for the purpose of the audit.

Users

Materiality in the context of an audit reflects the auditor’s judgment of the needs of users in relation to the information in the financial statements and the possible effect of misstatements therein. For an audit of general purpose financial statements, however, it is not practicable for the auditor to obtain an understanding and take account of the expectations of all the possible individual users of the financial statements. The proposed revised ISA 320 indicates that, in an audit of general purpose financial statements, the auditor’s judgment as to matters that are material to users of the financial statements is based on consideration of the needs of users as a group; the auditor does not consider the possible effects of misstatements on specific individual users, whose needs may vary widely.

Determining Materiality

The proposed revised ISA 320 introduces guidance on the use of percentages of benchmarks for the initial determination of materiality for the financial statements as a whole, when establishing the overall audit strategy. This guidance is not, however, intended to set formulaic rules for the

determination of materiality; it makes clear that the auditor may consider higher or lower percentages to be appropriate.

The proposed revised ISA 320 also requires the auditor to 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 (e.g., in relation to measurement or disclosure of certain items, such as related party transactions and the remuneration of management and those charged with governance).

Communication of Misstatements to Management

The proposed revised ISA 320 requires the auditor to communicate to management all known and likely misstatements identified during the audit, other than those that the auditor believes are clearly trivial, and to request management to correct all known misstatements. The IAASB believes that it is important to promote an environment in which the correction of misstatements is seen as the appropriate course of action, regardless of whether they are evaluated as material or not. Such an approach will also help to remove the difficulties that can arise in relation to the effect on current period financial statements of uncorrected prior period misstatements.

Evaluation of Uncorrected Misstatements

The guidance in the proposed revised ISA 320 makes clear that determining materiality levels does not establish thresholds below which identified misstatements are always considered to be immaterial when evaluating those misstatements and their effect on the auditor's report. The circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are of a lower level than the auditor had determined to be material when establishing the overall audit strategy. Examples are given of such circumstances.

Evaluation of Whether the Financial Statements as a Whole are Free of Material Misstatement

The proposed revised ISA 320 requires that, when evaluating whether the financial statements as a whole are free of material misstatement, the auditor should consider both the uncorrected misstatements and the qualitative aspects of the entity's accounting practices. The guidance indicates that during the audit, the auditor is alert for possible bias in management's judgments. The cumulative effect of 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. Examples are given of indicators of a lack of neutrality in management's judgments that the auditor takes into account.

Guide for Commentators

The IAASB welcomes comments on the proposed revised ISA 320. The IAASB is seeking comments on all matters addressed in the exposure draft. Comments are most helpful when they refer to specific paragraphs, include the reasons for the comments, and, where appropriate, make explicit suggestions for any proposed changes to wording. When a respondent agrees with

EXPLANATORY MEMORANDUM

proposals in this exposure draft (especially those calling for change in current practice), it will be helpful for the IAASB to be made aware of this view.

Recognizing that the revised ISA 320 will apply to audits of all sizes and in all sectors of the economy, the IAASB is also interested in comments on matters set out below:

Special Considerations in the Audit of Small Entities

Consistent with the IAASB's decision to include any special considerations relevant to the audit of small entities within the text of ISAs, the guidance in paragraphs 47 to 53 of International Auditing Practice Statement (IAPS) 1005, "The Special Considerations in the Audit of Small Entities," has been revised as considered necessary and incorporated in this proposed revised ISA. Consequently, paragraphs 47 to 53 of IAPS 1005 **will be withdrawn** when revised ISA 320 becomes effective. Respondents are asked to comment on whether, in their opinion, considerations in the audit of small entities have been dealt with appropriately in proposed revised ISA 320. Reasons should be provided if not in agreement, as well as suggestions for alternative or additional guidance.

Special Considerations in the Audit of Public Sector Entities

Special considerations in the audit of public sector entities have been included in the Public Sector Perspective at the end of the proposed revised ISA 320. The Public Sector Perspective was prepared by the Public Sector Committee (now the International Public Sector Accounting Standards Board) of the International Federation of Accountants. Respondents are asked to comment on whether, in their opinion, special considerations in the audit of public sector entities have been dealt with appropriately in the Public Sector Perspective. Reasons should be provided if not in agreement, as well as suggestions for alternative or additional guidance.

Translations

Recognizing that many respondents intend to translate the revised ISA 320 for adoption in their own environments, the IAASB welcomes comment on potential translation issues noted in reviewing this exposure draft.

**PROPOSED INTERNATIONAL STANDARD ON AUDITING 320
(REVISED)**

**MATERIALITY IN THE IDENTIFICATION AND EVALUATION OF
MISSTATEMENTS**

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

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International Standard on Auditing (ISA) 320 (Revised), “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 and how it is used in the identification and evaluation of misstatements when performing an audit of financial statements. The standards and guidance in the ISA are 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. 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. 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;
 - (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 (Revised), "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements".

Materiality in the Context of an Audit

6. 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 provides a different definition of materiality, the auditor uses that definition for the purpose of the audit.

Users

8. 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:
- (a) Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements 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;

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 ISA 540 (Revised), "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.

- (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 the information in the financial statements.

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

- 9. In an audit of general purpose financial statements, the auditor's judgment as to matters that are material to users of financial statements is based on consideration of the needs of users as a group; the auditor does not consider the possible effect of misstatements on specific individual users, whose needs may vary widely. 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.
- 10. 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.

Determining Materiality for the Financial Statements as a Whole when Planning the Audit

- 11. **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 (Revised), "Planning an Audit of Financial Statements"). Determining a materiality level for the financial statements as a 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 report. As discussed in paragraph 37, 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 when establishing the overall audit strategy.

Use of Percentages of Benchmarks

13. The determination of what is material to the users 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 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, financial performance and cash flows), or other specific requirements of that 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 before tax from continuing operations. Profit before tax 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 (e.g., an investment fund) an appropriate benchmark might be net assets.

14. Illustrative examples of percentages applied to benchmarks that might be considered include the following:
 - For a profit oriented entity, five percent of profit before tax from continuing operations, or one half of one percent of total revenues.
 - For a not-for-profit entity, one half of one percent of total expenses or total revenues.
 - For an entity in the mutual fund industry, one half of one percent of net asset value.

The auditor may consider higher or lower percentages than those illustrated above to be appropriate.

15. 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 a normalized profit figure based on past results.

16. 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.

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 the following:
 - Whether accounting standards, law or regulations affect users’ expectations regarding the measurement or disclosure of certain items (e.g., 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 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, could reasonably be considered material by the users of the financial statements.

Tolerable Error³

20. **The auditor should determine one or more levels of tolerable error for classes of transactions, account balances and disclosures.**

³ “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.

21. 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 levels determined in accordance with paragraphs 11 and 17 could, in the aggregate, result in a material misstatement of the financial statements. To do so, the auditor determines one or more levels of tolerable error. Such levels of tolerable error are lower than the materiality levels.

Considerations as the Audit Progresses

22. **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.**
23. 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.
24. If the auditor concludes that 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.
25. **The auditor should consider whether the overall audit strategy and audit plan need to be revised if 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.**
26. 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.
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 of Misstatements to Management

28. **The auditor should accumulate all known and likely misstatements identified during the audit, other than those that the auditor believes are clearly trivial,⁴ and communicate them to the appropriate level of management on a timely basis.**
29. 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 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 take the necessary action.
30. 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
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.

⁴ 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."

32. **The auditor should 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.**
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.
34. 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 the auditor's report (see paragraph 42).

Evaluating the Effect of Uncorrected Misstatements

35. **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.**
36. 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, including whether materiality levels for particular items of lesser amounts than the materiality level for the financial statements as a whole, determined in accordance with paragraph 17, have been exceeded;
 - (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.
37. 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. 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.

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.

38. 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), even if the effect of the misstatement is not material to the financial statements.

Evaluating Whether the Financial Statements as a Whole are Free of Material Misstatement

39. **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 evaluation of the uncorrected misstatements required in paragraph 35 and the qualitative aspects of the entity's accounting practices.**
40. 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 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 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.
41. **If the auditor believes that the financial statements as a whole are materially misstated, the auditor should request management to make the necessary corrections.** If management refuse to make the corrections the auditor considers the implications for the auditor's report (see paragraph 42).

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

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

43. 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

44. Standards and guidance regarding communications about materiality and misstatements to those charged with governance are set out in ISA 260, “Communication of Audit Matters with Those Charged with governance.”

Documentation

45. **The auditor should document:**

- (a) **The levels of materiality and tolerable error, including any changes thereto, used in the audit and the basis on which those levels were determined;**
- (b) **A summary of uncorrected misstatements, other than those that are clearly trivial, 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.**

46. 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 aggregate effect of 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

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

Public Sector Perspective

1. *In evaluating the materiality of a misstatement, the public sector auditor should consider 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.*



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