

Materiality in the Identification and Evaluation of Misstatements – Summary of Significant Comments and Task Force’s Recommendations

Introduction

1. Forty-eight comment letters were received on the exposure draft of the proposed revised ISA 320, “Materiality in the Identification and Evaluation of Misstatements,” (the “ED”) which was issued in December 2004. A list of respondents is included in the Appendix.
2. This paper summarizes the significant comments and the Task Force’s recommendations.

Overall Comments

3. Respondents were generally supportive of the revision to ISA 320, “Audit Materiality” and the proposed requirements and guidance in the ED. Respondents provided the following reasons for their support:
 - The significant improvements over the existing ISA 320.
 - The rigor introduced by the enhanced definition of materiality and the proposed new requirements and guidance on determining materiality.
 - The greater consideration given to the nature of an item (in addition to its size) and the circumstances of the entity when determining materiality and evaluating misstatements.
 - The move to address management bias.

Although respondents requested clarification in some areas or restructuring of the ED, no respondent opposed the proposed ISA as a whole, and there was broad support for all the requirements in the ED.

4. The comments indicated that the requirements and guidance generally were well balanced. However, concerns were raised about certain guidance that was perceived to be too prescriptive (for example, the guidance on percentages of benchmarks (see Significant Comment F)). This was illustrated by one respondent’s comments, as follows:

“Auditing standards in recent years have sought to increase the use of professional judgment and foster an attitude of professional skepticism, while at the same time providing additional guidance to auditors as to how judgment and skepticism can be applied. There is an inherent tension in this approach in that requirements to use a high level of professional judgment can be straitjacketed by an overly detailed level of prescriptive guidance, which is counterproductive. Auditing standards, particularly the body of auditing standards, are not always the best place for detailed guidance because of the tendency, rightly or wrongly, for auditors, regulators and others to interpret auditing standards in a legalistic manner.”

The Task Force agrees that the exercise of professional judgment is paramount in determining materiality and evaluating misstatements and, therefore, has kept the need for appropriate balance between requirements and guidance in mind when it evaluated the significant comments.

An ISA for Materiality and a Separate ISA for Misstatements

5. The Task Force is of the view that many of the comments can be attributed to the fact that respondents were confused by the flow of the requirements and guidance in the ED. The flow of the ED is affected because it addresses both the concept of materiality and the identification and evaluation of misstatements in one document. Some respondents, for example, suggested that the qualitative aspects of materiality, including the guidance on management bias, and the categories of misstatements be addressed earlier in the ISA. These matters, however, relate to the concept of misstatements and the auditor's evaluation of misstatements, which were addressed later in the ED. It was also not clear to some respondents that materiality is determined at the planning stage of the audit; considered, and adjusted if necessary, throughout the audit; and ultimately used to evaluate misstatements; or that the communication of misstatements with management is not a discrete phase of the audit, but rather a continual and iterative process.
6. The Task Force concluded that the clarity of the requirements and guidance, and flow thereof, would be enhanced by addressing materiality and misstatements in separate ISAs, i.e., an ISA on materiality in planning and performing an audit ("ISA 320") and an ISA on identifying and evaluating misstatements ("ISA XXX"). Based on the headings of the sections in the ED, the ED could be split as follows:

	Materiality	Misstatements
Introduction	☑	☑
Nature and Causes of Misstatements		☑
Materiality in the Context of an Audit	☑	
Users	☑	
Determining Materiality for the Financial Statements as a Whole when Planning the Audit	☑	
Use of Percentages of Benchmarks	☑	
Materiality for Particular Items of Lesser Amounts than the Materiality Level Determined for the Financial Statements as a Whole	☑	
Tolerable Error	☑	
Consideration as the Audit Progresses	☑	☑
Communication of Misstatements to Management		☑
Evaluating the Effect of Uncorrected Misstatements		☑
Evaluating whether the Financial Statements as a Whole are Free from Material Misstatement		☑
Evaluating the Overall Effect of Audit Findings on the Auditor's Report		☑

Communications with Those Charged with Governance	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Documentation	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Effective Date	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>

7. Many of the existing ISAs provide for the auditor to consider the effect of specified matters on the auditor's report. Proposed ISA 705, "Modifications to the Opinion in the Independent Auditor's Report," paragraph 7, requires the auditor to modify the opinion in the auditor's report when the auditor concludes that, based on the audit evidence obtained, the financial statements are not free of material misstatement, or when the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements are free of material misstatement. The Task Force believes that ISA XXX could be an important link between the existing ISAs and the proposed ISA 705, providing requirements and guidance on how to evaluate the effect of uncorrected misstatements on the financial statements and the related auditor's report.
8. Further, in the discussion of the Clarity Project at the September 2005 IAASB meeting, it was suggested that the IAASB should consider consolidating all the requirements and guidance relevant to forming an opinion on the financial statements in one new ISA. This could include (a) requirements and guidance on evaluating misstatements, (b) the guidance in ISA 700 (Revised), "The Auditor's Report on a Complete Set of General Purpose Financial Statements"), including the auditor's "stand-back" responsibility, and (c) requirements and guidance on concluding on the appropriateness and sufficiency of audit evidence.
9. The Task Force recognizes that there is a risk that the relationship between materiality and misstatements may not be as clear to some readers if the requirements and guidance are presented in two separate ISAs. The Task Force, however, is of the view that this could be overcome by ensuring that the titles of the ISAs clearly describe their content, and that the introductions to the ISAs clarify their relationship with each other, and with the other ISAs. The Task Force recognizes that it may be necessary to repeat, to a limited extent, in ISA 320 some of the text in ISA XXX to clarify the context in which materiality is used in planning and performing the audit.
10. To enable the IAASB to consider this recommendation, the ED text has been split and included in ISA 320 and ISA XXX. See Agenda Items 5-B and 5-C. These ISAs are for illustrative purposes only and, except for the Introduction sections, have not been changed to reflect the comments received on exposure.

Does the IAASB agree with the Task Force's recommendation to split the requirements and guidance into two separate ISAs (i.e., an ISA on materiality in planning and performing an audit and an ISA on identifying and evaluating misstatements)?

Significant Comments and Task Force's Recommendations

11. Significant comments relate to the following matters:
 - (a) The application of the proposed ISA to audits of small entities, public sector entities, and in special purpose audits

- (b) Management's responsibility for determining materiality and tolerable misstatement for financial reporting purposes
- (c) The definition of materiality
- (d) The users of financial statements
- (e) The qualitative aspects of materiality
- (f) The percentages of benchmarks
- (g) Inherent uncertainty associated with the measurement of particular financial statement items
- (h) Tolerable error
- (i) The categorization of misstatements (including misstatements involving subjective decisions), consideration of misstatements as the audit progresses, and communication of misstatements
- (j) Prior period uncorrected misstatements
- (k) Management bias

Based on your reading of the individual responses to the ED, does the IAASB agree with the list of significant comments identified by the Task Force?
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- (A) THE APPLICATION OF THE PROPOSED ISA TO AUDITS OF SMALL ENTITIES, PUBLIC SECTOR ENTITIES, AND IN SPECIAL PURPOSE AUDITS
12. Several respondents commented on the application of the ED to audits of small entities, public sector entities, and in special purpose audits. One respondent suggested that the public sector entity audit considerations should be included in the body of the ISA.

Task Force's Recommendation

Small Entities

13. The Task Force believes that the proposed requirements and guidance apply equally to audits of large and small entities. As noted in the Invitation to Comment in the ED, the guidance in paragraphs 47-53 of IAPS 1005, "The Special Considerations in the Audit of Small Entities," were revised as considered necessary and incorporated in the ED.
14. The comments received relating to audits of small entities were in the following areas: the definition of materiality, the users of financial statements, the qualitative aspects of materiality, the benchmarks and percentages of benchmarks, tolerable error, the correction of misstatements, and management bias. The Task Force is of the view that most of the comments have been addressed by the recommendations that follow.

Public Sector Entities

15. The comments received relating to audits of public sector entities were in the following areas: the definition of materiality, the users of financial statements, the qualitative

aspects of materiality, the benchmarks and percentages of benchmarks, and the communication of misstatements. The Task Force will liaise with the IFAC International Public Sector Accounting Standards Board and with an appropriate sub-group of the INTOSAI Professional Standards Committee to revise the public sector perspective based on comments received.

16. Whether public sector entity audit considerations ought to be included in the body of the ISAs is a policy decision to be taken by the IAASB.

Special Purpose Audits

17. The Task Force continues to be concerned about the requests for additional guidance on the application of the requirements and guidance to special purpose audits (i.e., audits of other historical financial information prepared for a special purpose). The Task Force understands the respondents' concern that the statement in ED-ISA 320.1 (that the requirements and guidance ought to be adapted for audits of historical financial information other than financial statements) is not overly helpful. The Task Force, however, is concerned that, while the requirements in the ED broadly apply to special purpose audits, the guidance in itself is not sufficient to demonstrate how the requirements would be applied in the particular circumstances of those engagements.
18. The Task Force is of the view that the materiality considerations in special purpose audits are too complex to be addressed in a limited number of paragraphs in ISA 320. Examples of such complexities include the following:
 - Linking the definition of materiality in the context of an audit to the definition of materiality in the applicable financial reporting framework (see Significant Comment C) will be complicated by the wider definition of financial reporting framework in paragraph 10 of proposed ISA 701, "The Auditor's Report on Other Historical Financial Information." Examples include: (a) adapting a definition of materiality that was developed in the context of the financial statements as a whole to an audit of a particular component of the financial statements, or (b) determining how information previously audited to a higher level of materiality in the audit of financial statements that is an input to the component of the financial statements being audited might affect the auditor's judgments of materiality and evaluation of misstatements in relation to the audit of that component.
 - The question of whether an audit conducted using a specified materiality (e.g., materiality agreed with a responsible party in the case of a special purpose audit, or materiality determined by the group auditor for purposes of an audit of a component) can be said to have been conducted in accordance with ISAs, given the fact that the application of materiality has such a pervasive effect on how many of the requirements in the ISAs are applied.

Such issues are important and worthy of more comprehensive exploration than the Task Force has been able to do, as it was not considered part of the original project terms of reference. The Task Force is aware that the Special Reports Task Force had provided suggestions for some limited guidance that could be incorporated into ISA 320 to give recognition of these other circumstances. The Task Force, however, believes that it could

be potentially misleading to include only a few high level comments in ISA 320 as it may convey to readers that sufficient guidance has been given to guide the judgments of auditors in those other circumstances, which clearly is not the case.

19. To date, ISAs – with the exception of proposed ISA 701 – have been written in the context of audits of financial statements. The IAASB has not taken a formal decision on whether in future the practice of incorporating special considerations for audits of other historical financial information in the ISAs should be adopted.
20. For these reasons, the Task Force recommends that the statement in ED-ISA 320.1 and the special consideration for audits of other historical financial information in ED-ISA 320.10 be deleted.

Does the IAASB agree with the Task Force’s recommendation to (a) delete the statement in ED-ISA 320.1 and the guidance in ED-ISA 320.10, and (b) not develop additional guidance on the application of ISA 320 to an audit of other historical financial information? If the IAASB disagrees, what additional guidance should be provided in the ISA?

(B) MANAGEMENT’S RESPONSIBILITY FOR DETERMINING MATERIALITY AND TOLERABLE MISSTATEMENT FOR FINANCIAL REPORTING PURPOSES

21. Some respondents (ACCA, ICAEW, FEE, KPMG, IDW) were of the view that the auditor, when determining materiality for planning and performing the audit, should consider either management’s process for determining materiality and tolerable error for financial reporting purposes; or the materiality and tolerable error that management has determined for financial reporting purposes. These respondents were of the view that inappropriate determination of materiality and tolerable error levels, or their incorrect application, on the part of management represents a risk that may cause the financial statements to be materially misstated.

Task Force’s Recommendation

22. The Task Force recognizes that management implicitly considers (a) a concept of “tolerance” when designing and implementing systems of internal control to ensure complete and accurate financial reporting and to prevent or detect and correct misstatements due to fraud or error (e.g., when determining a dollar amount or percentage for exception reports, or when establishing approval limits), and (b) a concept of “materiality” when preparing the financial statements because management makes judgments on whether information is sufficiently significant that its omission or misstatement could influence the decisions of users taken on the basis of the financial statements and, therefore, ought to be separately presented or disclosed. It is the Task Force’s view, however, that management normally does not have a formal process for determining materiality and tolerable error for financial reporting purposes, and that management generally does not consider materiality in the same way as the auditor (other than when weighing the merits of additional presentation or disclosures in the financial statements, and correcting misstatements identified by the auditor).

23. Although not explicitly referred to in ISA 315, “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement,” the auditor would obtain an understanding of and assess management’s general attitude towards materiality in the context of internal control and fair presentation of the financial statements through the auditor’s risk assessment procedures. Thus, in the Task Force’s view, ISA 315 already accomplishes the consideration that some respondents thought important. The Task Force does not consider it necessary to propose conforming amendments to ISA 315.
24. The Task Force is concerned that an explicit requirement (in ISA 320) for the auditor to obtain an understanding of management’s process for determining materiality and tolerable error, or of management’s materiality and tolerable error, may be interpreted as the auditor substituting management’s judgment for his or her own responsibility to determine materiality and tolerable error for purposes of planning and performing the audit. For this reason, the Task Force is of the view that it is not appropriate to include additional requirements and guidance in ISA 320.
25. The Task Force’s recommendation is consistent with the conclusion reached by the IAASB prior to approving the ED. At its September 2004 meeting, the IAASB agreed that the ED should not require the auditor, when determining materiality for planning and performing the audit, to consider the materiality, if any, used by management when preparing the financial statements.

Does the IAASB agree with the Task Force’s recommendation not to refer to management’s materiality and tolerable error in ISA 320? Does the IAASB agree with the Task Force’s recommendation not to process any conforming amendments to ISA 315 to specifically refer to management’s consideration of materiality?

(C) THE DEFINITION OF MATERIALITY (ED-ISA 320.6-7)

26. While some respondents explicitly supported the definition of materiality in the ED (and the fact that it is taken from International Accounting Standard (IAS) 1, “Presentation of Financial Statements”), other respondents (AGNZ, AICPA, Basel, CEBS, CIPFA, E&Y, FAR, FEI, IAA, IDW, JICPA, PPB) were of the view that the definition of materiality should be revised. Reasons for this comment included the following:

Definition of Misstatement

- The IAS 1 definition of materiality is helpful, but not necessarily complete. Materiality is equally important for items that are or ought to be disclosed in addition to “omissions or misstatements of items.”
- The limitation of the definition to “omissions or misstatements of items” effectively excludes auditor concerns about management behavior, which does not directly affect the fair presentation of the financial statements. For example, when management has invested unlawfully or without authority. In this instance, the financial statements may fairly reflect the investment – albeit that the investment is unlawful or unauthorized.

Definition of Materiality

- The use of the word “could” in the IAS 1 definition without a modifier such as “reasonable,” establishes a very low threshold of materiality. A requirement for the auditor to plan an audit to detect what “could” influence the economic decisions of users may be unreasonable and impractical, especially when dealing with the needs of users of general purpose financial statements.
- The limitation of the definition to “economic decisions of users” fails to recognize that users may choose to make decisions other than economic decisions.
- The IAS 1 definition is for general purpose financial statements. ISA 320 is applicable to the audit of general purpose as well as special purpose financial statements. Consequently, the scope of ISA 320 is broader than the scope of IAS 1.
- ISAs should be neutral regarding the financial reporting framework. It is therefore suggested that the ISA includes its own definition of materiality that can be applied by every auditor, regardless of the financial reporting framework.
- Because it is difficult to define materiality appropriately, the auditor can use the IAS 1 definition of materiality as a reference, as long as the definition is shown as an example.

Task Force’s Recommendations

Definition of Misstatement

27. Confusion about the terms “omission” and “misstatement” could be eliminated by clearly describing the term “misstatement” in ISA XXX (i.e., by clarifying that misstatements include omissions of required amounts or disclosures). It will also assist in (a) responding to the comments of some respondents (HKICPA, IDW, IRE, PWC) that the guidance on the nature and causes of misstatements in ED-ISA 320.4-5 would benefit from an overarching principle or definition of a misstatement, and (b) eliminating the overlap in examples in ED-ISA 320.4(a)-(e). Proposed text is as follows:

A misstatement is a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. A misstatement includes an omission of an amount or a disclosure that is required by the applicable financial reporting framework or, in the auditor’s professional judgment, is otherwise needed for the fair presentation of the financial statements. Misstatements can arise from error or fraud, and include:

- (a) An inaccuracy in gathering or processing data from which the financial statements are prepared;
- (b) An incorrect accounting estimate arising, for example, from an oversight or misinterpretation of facts; and
- (c) Differences between management’s and the auditor’s judgments concerning accounting estimates, or the selection or application of accounting policies that the auditor considers inappropriate.

The proposed text only reflects the Task Force’s recommended response to the request for an overarching principle or definition of misstatement. The examples in (a)-(c) do not reflect other comments received on the examples in ED-ISA 320.4(a)-(e). Those comments will be considered when the Task Force revises the detailed text of the ED.

Does the IAASB agree with the proposed definition of “misstatement?”

Definition of Materiality

28. The Task Force debated whether to recommend a stand-alone definition of “audit materiality,” as suggested by some respondents. The Task Force, however, noted that:
- Both “accounting materiality” (as defined in IAS 1) and “audit materiality” are based on the concept of users’ perceptions. Thus, although management and auditors approach their materiality judgments from different perspectives (i.e., management from the perspective of what needs to be included in the financial statements to fulfill their reporting obligations, and the auditor from the perspective of whether there are misstatements in the financial statements), the underlying concept of materiality is the same.
 - The auditor expresses his or her opinion on the financial statements in the context of the applicable financial reporting framework.

For these reasons, the majority of Task Force members continue to believe that the starting point for the auditor is the definition of materiality in the applicable financial reporting framework.

29. However, to clarify materiality in the context of an audit, and its relationship with materiality as defined in the applicable financial reporting framework, the Task Force proposes the following changes to ED-ISA 320.6-7:

As stated in ISA 200, “Objective and General Principles Governing an Audit of Financial Statements,” the objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. The auditor is concerned with misstatements that either individually or in the aggregate could be material to the financial statements. The auditor therefore plans and performs the audit to obtain reasonable assurance that material misstatements are detected.

The auditor’s consideration of materiality is a matter of professional judgment, and is affected by the auditor’s perception of the financial information needs of the users of the financial statements. In this context, 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; (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 decisions on the basis of the information in the financial statements. Furthermore, the auditor’s consideration of materiality is based on 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 definition of materiality in the applicable financial reporting framework provides a frame of reference to the auditor when determining materiality for planning and performing the audit. For example, International Accounting Standard (IAS) 1, “Presentation of Financial Statements,” defines materiality 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.” Other financial reporting frameworks designed for a general purpose may define materiality differently but, to the extent that the underlying principles are similar, the auditor’s judgment as to what would be material in the circumstances is not expected to vary significantly.

Does the IAASB agree that the definition of materiality in the context of an audit should be by reference to the definition of materiality in the applicable financial reporting framework? Does the IAASB agree with the proposed changes to ED-ISA 320.6-7?

(D) THE USERS OF FINANCIAL STATEMENTS (ED-ISA 320.8-10)

30. Many respondents were of the view that the guidance on the characteristics of users of the financial statements in ED-ISA 320.8 needs to be revised (ACAG, ACCA, AUASB, Basel, CEBS, CPA Australia, E&Y, FEE, FEI, GT, HKICPA, ICAEW, ICAP, ICAS, INTOSAI, IOSCO, IRE, PAAB, PWC).
31. One respondent (IOSCO), for example, noted that the user characteristics in ED-ISA 320.8, particularly those in (a), (b) and (c), do not assist auditors in making appropriate judgments about materiality for purposes of the audit. This respondent was of the view that the characteristics create expectations about the nature of users that appear to be an attempt by auditors to “risk manage” expectations about the objective of an audit and the nature of reasonable assurance. The objectives of an audit, the concept of reasonable assurance, and the assumption of a wide range of users are already dealt with in ISA 200, “Objective and General Principles Governing an Audit of Financial Statements,” and other ISAs. Auditors need to determine materiality in the context of the financial statements and the guidance provided in the applicable financial reporting framework, including relevant laws and regulations, or IFRS, if the applicable financial reporting framework does not provide guidance. Some respondents (Basel, CEBS, IRE, IOSCO) suggested deleting ED-ISA 320.8. One respondent (IRE) suggested a reference to “informed users” instead, and noted that the auditor could refer to the applicable financial reporting framework for guidance on what “informed” means. Another respondent (FEI) suggested a reference to “reasonable user” in the definition of materiality.
32. One respondent (Basel) was also not convinced of the reasoning in ED-ISA 320.9, in particular, that the collective needs of investors as a group form an appropriate frame of reference for determining materiality. Another respondent (CEBS) was of the view that auditors will refer to the applicable financial reporting framework in this regard. This respondent, for example, noted that for banks there are many significant stakeholders, such as banking supervisors. Two respondents (Basel, CEBS) suggested deleting ED-ISA 320.9.

Task Force’s Recommendation

33. The purpose of the guidance in ED-ISA 320.8 was not, as suggested by some respondents, to define users but rather to define the context in which users of the financial statements make decisions. Since the auditor considers the materiality of a misstatement based on whether it could reasonably be expected to influence the decisions of users, the Task Force considers it useful to provide guidance on the context in which users make decisions. Such guidance, however, may be better placed in a generic context in the definition of materiality, as proposed in paragraph 29 above. The Task Force therefore recommends that:
- ED-ISA 320.8(a), which refers to the fact that users are assumed to have a reasonable knowledge of business and economic activities and accounting, and a

willingness to study the information in the financial statement with reasonable diligence (and which is in line with IAS 1.12), be retained and incorporated in revised ED-ISA 320.6-7 (see paragraph 29 above).

- ED-ISA 320.8(b), which refers to the fact that users are assumed to 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, be retained, but that the reference to the relationship between the level of materiality used and the cost and timing of the audit be deleted. Although the reference to cost and timing is not incorrect, the matter would be better discussed in the context of ISA 200, “Objective and General Principles Governing an Audit of Financial Statements,” as proposed as part of the Clarity Project. It is further recommended that the redrafted text be incorporated in revised ED-ISA 320.6-7 (see paragraph 29 above).
 - ED-ISA 320.8(c), which refers to the fact that users are assumed to recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events, be retained and incorporated in revised ED-ISA 320.6-7 (see paragraph 29 above).
 - ED-ISA 320.8(d), which refers to the fact that users are assumed to make reasonable economic decisions on the basis of the information in the financial statements, be retained and incorporated in revised ED-ISA 320.6-7 (see paragraph 29 above).
34. The comments on ED-ISA 320.9 relate to the fact that the respondents were concerned that particular groups of users, such as regulators, have not been acknowledged, rather than the fact that the auditor considers the needs of users *as a group*. To eliminate confusion, the Task Force recommends that the reference to the collective needs of *investors* as a group as an appropriate frame of reference when determining materiality be deleted. The Task Force also recommends that the redrafted text be incorporated in revised ED-ISA 320.6-7 (see paragraph 29 above).

Does the IAASB agree with the Task Force’s recommendation that it is appropriate to provide guidance on the context in which users of the financial statements make decisions? If so, does the IAASB agree with the redrafted guidance and with the incorporation thereof in revised ED-ISA 320.6-7?

(E) THE QUALITATIVE ASPECTS OF MATERIALITY

35. Many respondents (AUASB, CEBS, Deloitte, FAR, FEE, FEI, GT, IDW, ICAS, INTOSAI, IOSCO, PAAB, PPB) identified the need for more prominent guidance on the qualitative aspects of materiality. Respondents referred to the examples in ED-ISA 320.37, noting that such qualitative aspects should be considered at an earlier stage of the audit process – not only at the stage of evaluating uncorrected misstatements. They were also concerned that the guidance on the use of percentages of benchmarks (ED-ISA 320.13-14) unduly emphasizes the quantitative aspects when determining materiality for planning and performing the audit (see Significant Comment F below).

Task Force's Recommendation

36. Whilst there are qualitative aspects that affect the auditor's professional judgment in determining materiality and tolerable error for planning and performing the audit, the qualitative aspects of materiality take on greater prominence when evaluating the effect of uncorrected misstatements on the financial statements and related auditor's report. ED-ISA 320.37, under the heading Evaluating the Effect of Uncorrected Misstatements, explains that "[t]he 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." In response to the comments, the Task Force recommends that this fact be stated earlier in ISA 320, for example following revised ED-ISA 320.6-7 and preceding the section on Determining Materiality for the Financial Statements as a Whole when Planning the Audit. Proposed text is as follows:

Whether a misstatement or aggregate of misstatements is material depends on the size and nature of the misstatement or aggregate of misstatements judged in the surrounding circumstances. The size or nature, or both, of a misstatement or aggregate of misstatements could be the determining factor. Although the auditor is alert for misstatements that could be material because of their nature, it ordinarily is not practical to design audit procedures to detect such misstatements. Consequently, the auditor considers the nature and size of an uncorrected misstatement, or aggregate of uncorrected misstatements, judged in the surrounding circumstances, when evaluating its effect on the financial statements and the related auditor's report *[insert cross reference to ED-ISA 320.37 text]*. When determining materiality for planning and performing the audit, the auditor, however, considers whether there are particular classes of transactions, account balances or disclosures for which materiality lower than the materiality at the financial statement level ought to be determined *[insert cross reference to ED-ISA 320.17-19 text]*.

37. This recommendation is in line with a previous conclusion reached by the IAASB. Before finalizing the ED, the IAASB debated whether qualitative aspects (such as those referred to in ED-ISA 320.37) should be taken into account when determining materiality for planning and performing the audit. The IAASB concluded that such qualitative aspects need not be taken into account when determining materiality for planning and performing the audit because they could give rise to very low levels of materiality. This would not be practical and not likely in line with users' expectations.
- (F) THE PERCENTAGES OF BENCHMARKS (ED-ISA 320.13-14)
38. On balance, respondents supported the guidance on benchmarks in ED-ISA 320.13. One respondent (AICPA) suggested emphasizing the fact that other entities might use other benchmarks. Some respondents (AUASB, CIPFA, Deloitte, GT, ICPAK) suggested including additional factors to be considered by the auditor in identifying an appropriate benchmark, or expanding the examples of benchmarks. One respondent (IAA) asked the IAASB to consider whether materiality might consist of more than one benchmark.
39. Many respondents questioned whether it is advisable to include examples of percentages that might be applied to benchmarks (see ED-ISA 320.14) in the proposed ISA. They were concerned that:
- Such "rules of thumb" will become the "standard," resulting in auditors applying those percentages without giving proper regard to the types of matter identified in

ED-ISA 320.13 and 15 and forming judgments based on a thorough consideration of the circumstances;

- The examples give undue emphasis to the quantitative aspects of materiality, when the qualitative aspects are important (however, see Significant Comment E above); and
 - The examples might encourage those responsible for inspecting an audit engagement to focus on why the auditor did not apply the given percentages, rather than how the auditor determined a particular percentage.
40. Consequently, many respondents supported either deleting (Cowperthwaite, FAR, ICAS, ICAZ, INTOSAI, JICPA, PKF, PWC) the examples of percentages that might be applied to benchmarks; or moving them to an appendix (AUASB, CNCC, FEE, HKICPA, ICAEW, INTOSAI), or “guidance note” (AICPA, CIPFA). Other respondents (Deloitte, IOSCO, IDW) advocated changes to the guidance, but did not suggest deleting or moving them. Many respondents (ACCA, E&Y, CGA Canada, CPA Australia, FEE, Deloitte, ICAI, ICAS, IDW, INTOSAI, PKF) suggested re-evaluating or expanding the examples (both the benchmarks and percentages), or providing ranges of percentages.
41. Some respondents (ACCA, ICAI, IRE) also suggested expanding the guidance to include factors that the auditor would take into account in determining the percentage to be applied to a benchmark.

Task Force Recommendation

42. As a result of the comments received, the Task Force considered the following alternatives, some of which were suggested by respondents:
- Moving the examples of percentages to an appendix. The Task Force, however, is not convinced that all respondents who suggested this alternative are aware that appendices have the same level of authority as the Standard.¹ (Under the new clarity drafting convention, the examples will form part of the application guidance (whether included in the application guidance or a separate appendix), which has the same authority as the remainder of the Standard). Furthermore, the examples in the ED are not sufficiently comprehensive to warrant being an appendix on their own and the creation of an appendix that includes more comprehensive guidance is not possible without further research.
 - Presenting the examples of percentages in a guidance note. Although the IAASB does not develop guidance notes, it could consider developing an International Auditing Practice Statement (IAPS) to provide additional guidance on the implementation of ISA 320 and, in particular, the benchmarks and percentages of benchmarks. As indicated above, such additional guidance would not be possible

¹ Preface to the International Standards on Quality Control, Auditing, Assurance and Related Services, paragraph 16: “The IAASB’s Standards contain basic principles and essential procedures (identified in bold type lettering) together with related guidance in the form of explanatory and other material, including appendices. The basic principles and essential procedures are to be understood and applied in the context of the explanatory and other material that provide guidance for their application. It is therefore necessary to consider the whole text of a Standard to understand and apply the basic principles and essential procedures.”

without further research. The development of an IAPS ought to be deferred until such time as the IAASB decides on the future of IAPSs as part of the Clarity Project.

- Deleting the examples. The guidance on percentages is useful and should not necessarily be deleted.
- Limiting the examples to just one. This is the Task Force's preferred approach. The guidance on the determination of a percentage should indicate that the percentage is based on the auditor's professional judgment, which is affected by the circumstances of the entity. The examples could be limited to one example of five percent of profit before tax from continuing operations for a manufacturing profit oriented entity, but clearly stating that other percentages may also be appropriate, depending on the circumstances. This example appeared to be the most acceptable and to have the widest application. (Although this recommendation does not address the request for industry specific percentages, such examples could not be provided without further research.)

43. The Task Force has concerns about providing examples of *ranges* of percentages. Providing ranges of percentages does not make it clearer that they are just examples and may be interpreted as providing the lowest and highest allowable percentages.

44. In the context of the above, it is proposed that the guidance in ED-ISA 320.13-14 be revised as follows:

13. Determining what is material to the users of the financial statements requires the exercise of professional judgment. The auditor often applies a percentage to a chosen benchmark as a starting point in determining materiality at the financial statement level. The use of percentages of benchmarks provides, for each engagement, a consistent starting point to which the auditor may then make adjustments for the particular circumstances of the entity.

13a. When identifying an appropriate benchmark, the auditor has regard to factors such as:

- The elements of the financial statements defined in the applicable financial reporting framework (e.g., assets, liabilities, equity, income, expenses, financial position, financial performance and cash flows), or other specific requirements of that framework;
- Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, whether revenue, profit, a particular asset, etc. is the most significant factor influencing users' perception of value for entities of that nature and in that industry);
- The nature of the entity, its life cycle, and the industry and economic environment in which it operates; and
- The size of the entity, nature of its ownership and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings).
- The relevance of the benchmark to the financial statement as a whole, and the relative volatility of the benchmark.

13b. Profit before tax from continuing operations may be an appropriate benchmark for profit-oriented entities. When an entity's profit before tax from continuing operations is volatile, other benchmarks may be appropriate, such as profit before tax adjusted for unusual or non-recurring revenue or expense items. When an entity's profit before tax from continuing operations is consistently nominal, as might be the case for an owner-managed business where the owner takes much of the profit before tax in the form of remuneration, a benchmark such as profit before remuneration and tax may be appropriate. Depending on

the particular circumstances of the entity, another benchmark may be more appropriate. Other benchmarks that may be appropriate in particular circumstances include total equity, net asset value, current assets, net current assets, total revenue, gross profit, other categories of reported income, total expenses, and cash flows from operations.

14. The auditor exercises professional judgment in determining a percentage to apply to the chosen benchmark. For example, the auditor may determine that five percent of profit before tax from continuing operations is an appropriate percentage in the case of a profit oriented entity in a manufacturing industry. Depending on the particular circumstances of the entity, another percentage may be more appropriate.

Does the IAASB support the Task Force's recommendation to redraft the guidance on percentages and to limit the examples?

- (G) INHERENT UNCERTAINTY ASSOCIATED WITH THE MEASUREMENT OF PARTICULAR FINANCIAL STATEMENT ITEMS (ED-ISA 320.16)
45. Some respondents explicitly supported the guidance in ED-ISA 320.16, which states that materiality is determined without regard to the degree of inherent uncertainty associated with the measurement of particular items. Several other respondents (ACCA, AUASB, Basel, HKICPA, ICAEW, ICAS, IDW, GT, PWC), however, raised issues in relation to the guidance.
- One respondent (ACCA) was of the view that underlying the example in the paragraph is a large area of debate about the users' understanding of the concept of reasonable assurance and the interaction between materiality and audit risk. This respondent was of the view that without considerably more explanation (for which an ISA is not the place) it is difficult to justify its inclusion.
 - Other respondents (AUASB, ICAEW, PWC) believed that the guidance is not particularly helpful to the auditor and is counter-intuitive. A respondent argued that, where an entity operates in an industry with high inherent uncertainty associated with the measurement of a particular item, such as an insurance company with long tail general provisions, the auditor will consider the significant risks of material misstatement associated with that particular item, and determine materiality relevant to that particular item. This respondent, however, did not agree that this will have no effect on materiality determined for the financial statements. If that particular item has a significantly high degree of estimation uncertainty, an incorrect calculation could be so pervasive that it will affect the financial statements as a whole. The auditor might have to consider this factor when determining materiality for the financial statements.
 - Another respondent (Basel) noted that the paragraph would benefit from additional considerations for auditors where the financial statements contain a number of estimates.
 - One respondent (IDW) suggested that the first sentence of the paragraph should be amended to read: "Materiality is independent of the degree of inherent uncertainty associated with the measurement of particular items." Tolerable error, on the other hand will be directly affected. This should be made clear in the section covering tolerable error. Another respondent (GT) had made a similar comment.

Task Force's Recommendation

46. The guidance intended to clarify that the auditor does not adjust materiality determined for planning and performing the audit when, in the case of an accounting estimate, the range of reasonable outcomes is larger than materiality. The Task Force is of the view that the concept will be more easily understood in the context of the guidance in proposed ISA 540, "Auditing Accounting Estimates and related Disclosures (Other than Those Involving Fair Value Measurements and Disclosures)" and recommends that ED-ISA 320.16 be deleted.

Does the IAASB agree with the deletion of ED-ISA 320.16?

(H) TOLERABLE ERROR (ED-ISA 320.20-21)

47. Many respondents raised issues about the guidance on tolerable error in ED-ISA 320.20 and 21.
48. Given that misstatements may be due to error or fraud, some respondents (Deloitte, FEE, IAA) recommended that the term "tolerable error" should be replaced by "tolerable misstatement," and that conforming amendments should be made to ISA 530, "Audit Sampling and Other Means of Testing," and elsewhere as necessary. Other respondents (HKICPA, PWC) were of the view that the term "tolerable error" should be replaced by "planning materiality."
49. Many respondents (AICPA, AUASB, CGA Canada, CPA Australia, Deloitte, FEE, FEI, HKICPA, IAA, IOSCO, KPMG, PWC) were of the view that the requirements and guidance should explain (a) how the levels of tolerable error relate to materiality, (b) the factors that affect the determination of the levels of tolerable error, (c) how the levels of tolerable error may be determined, and (d) how tolerable error is used in performing the audit. Specific comments included the following:
- One respondent (Deloitte) questioned ED-ISA 320.20, which states that "[t]he auditor should determine one or more levels of tolerable error for classes of transactions, account balances and disclosures." ED-ISA 320.21, however, refers to ED-ISA 320.17, where it is contemplated that the auditor may establish more than one level of materiality when there are particular items that warrant materiality levels lower than the materiality level determined for the financial statements as a whole.
 - One possible interpretation is that multiple levels of tolerable error are only required when there are multiple levels of materiality as contemplated in ED-ISA 320.17.
 - Another interpretation is that multiple levels of tolerable error may be necessary for classes of transactions, account balances and disclosures to ensure that the aggregate misstatement in the financial statements is not material. In other words, even if there are no ED-ISA 320.17-type lower levels of materiality, it may still be necessary to establish more than one level of tolerable error for classes of transactions, account balances or disclosures.

- The ambiguity arises because multiple levels of tolerable error may be necessitated by multiple levels of materiality, by multiple classes of transactions, account balances and disclosures, or by both.
- One respondent (Deloitte) was of the view that audit risk is the key concept linking tolerable error and materiality. Levels of tolerable error should be determined for classes of transactions, account balances and disclosures in a way that ensures that, if the risk that such levels could be exceeded is acceptably low, in aggregate, the risk that the total misstatement in the financial statements could exceed materiality will also be acceptably low.
- One respondent (CNCC) noted that the concept of tolerable error is linked to statistical sampling, and that this link should be made clear in ED-ISA 320.20. Another respondent (FEE) was of the view that it is necessary to include different definitions for tolerable error for sample sizes as compared to classes of transactions, account balances and disclosures.

Task Force's Recommendation

50. The purpose of the requirement and guidance on tolerable error was to require the auditor, in performing risk assessment and further audit procedures, to allow for the possibility that the aggregate of individually immaterial misstatements could be material. In practice, various terms are used to describe this concept. Reference to the term “tolerable error” in the ED created confusion and requests for additional guidance on the approach to be followed in determining tolerable error. The majority of Task Force members believe that it would not be possible to promote in the Standard one approach for determining tolerable error because the Task Force is not aware of any persuasive evidence to support one approach over the others, or that the quality of audits is directly affected by the approach used.
51. To eliminate confusion, however, the Task Force recommends that the guidance in ED-ISA 320.20-21 be revised to explain the concept in general terms (i.e., without reference to the term “tolerable error”). Proposed text is as follows:

The auditor should set an amount lower than materiality determined at the financial statement level or materiality determined for a particular class of transactions, account balance or disclosure to use when assessing the risks of material misstatement or when designing and performing further audit procedures to respond to assessed risks. When using materiality determined at the financial statement level or materiality determined for a particular class of transactions, account balance or disclosure to assess the risks of material misstatement or to design and perform further audit procedures to respond to assessed risks, the auditor allows for the possibility that the aggregate of individually immaterial misstatements could be material. The auditor’s determination of this lower amount is affected by the nature and extent of misstatements accumulated in previous audits. In the case of audit sampling, this lower amount is the tolerable error referred to in ISA 530, “Audit Sampling and Other Means of Testing.”

Does the IAASB agree with the Task Force’s recommendation not to develop an approach for determining tolerable error? If so, does the IAASB agree with the revised requirement and guidance?

- (I) THE CATEGORIZATION OF MISSTATEMENTS (INCLUDING MISSTATEMENTS INVOLVING SUBJECTIVE DECISIONS), CONSIDERATION OF MISSTATEMENTS AS THE AUDIT

PROGRESSES, AND COMMUNICATION OF MISSTATEMENTS (ED-ISA 320.31, 27 AND 28-34)

52. Many respondents took the view that the categorization of misstatements in ED-ISA 320.31 should be revised. (ACCA, AICPA, AUASB, Basel, CICA, CNCC, DNR, E&Y, FEE, GT, HKICPA, ICAEW, ICAS, IDW, PAAB, PKF, PWC.) Most of these respondents were concerned about the misstatements involving subjective decisions as a subset of known misstatements.
- One respondent (GT) was of the view that the different categories of misstatements should be described earlier in the ISA, i.e., when the nature and causes of misstatements are discussed.
 - Many respondents (ACCA, AICPA, AUASB, CNCC, DNR, FEE, HKICPA, ICAEW, IDW, PKF, PWC) did not believe that a misstatement involving subjective decisions is a known misstatement. They were of the view that a misstatement can only be known if it is a misstatement of fact. If the misstatement has arisen because there is a difference between management's and the auditor's judgment concerning an estimate, the quantum of the misstatement can not be known for a fact. This is because it is not known, for a fact, which of the two estimates is the correct one and hence what the misstatement is. Another respondent (E&Y) suggested that the ISA explain why misstatements involving subjective decisions are considered to be known misstatements. Two respondents (FEE, IDW) suggested that the terms "presumed known misstatement," with subcategories "presumed misstatements of fact" and "presumed misstatements involving subjective decisions," are used until such misstatements are confirmed as misstatements. Other respondents suggested "misstatements of fact," "misstatements involving subjective decisions" (as two separate categories), and "projected misstatements."
 - One respondent (AICPA) noted that a difference between management's and the auditor's accounting estimate is more appropriately categorized as a likely misstatement, i.e., a misstatement that the auditor considers likely to exist based on an extrapolation of audit evidence obtained. This respondent argued that a sample result is based on a probability assessment, so the nature of the misstatement arising from this process should be the same in either subjective or objective (sample) estimation. It is inconsistent that a probability assessment of a subjective estimate would result in a known misstatement, whereas a probability assessment of an objective estimate would result in a likely misstatement.
 - One respondent (CNCC) noted that the term "material misstatement of fact" is used in ISA 720, "Other Information in Documents Containing Audited Financial Statements" for incorrectly stated or presented information, which the auditor identified by reading other information in documents containing audited financial statements. The nature of these material misstatements of facts are different from that of the misstatements of fact discussed in ED-ISA 320.31. The respondent suggested that the same term should not be used for both.
 - One respondent (Basel) suggested deleting the words "misinterpretation of facts" in the misstatements of fact subcategory because, by definition, an interpretation

involves the use of judgment and is therefore subjective. The respondent was of the view that interpretations should form part of the misstatements involving subjective decisions.

- Two respondents (FEE, PWC) suggested that the IAASB use terms that are close to describing the actual guidance. The term “likely misstatement” is applied to a misstatement that might exist from an extrapolation for audit evidence, i.e., a “projected misstatement.” These respondents suggested that the term “likely misstatement” should be replaced by “projected misstatement.”
53. One respondent (KPMG) noted that the term “undetected misstatements” in ED-ISA 320.27 is not defined. The respondent was concerned that this lack of guidance could result in varying interpretations and thus inconsistencies in practice. It was suggested that the proposed ISA should include additional guidance on how the auditor would practically carry out the requirements of ED-ISA 320.27, and when specific undetected misstatements need to be considered, e.g., sampling risk arising from the application of representative sampling.
54. Other respondents (ACCA, FEE, HKICPA, ICAEW, IDW) were of the view that the ED draws an arbitrary line by requiring auditors to request correction of all known misstatements, which includes misstatements involving subjective decisions, while further investigation of misstatements by management is limited to likely misstatements. In practice, management and auditors may seek to resolve many misstatements involving subjective decisions and likely misstatements at different stages during the audit (perhaps altering the preliminary categorization of misstatements involving subjective decision to misstatements of fact).
55. Some respondents (FSR, HKICPA, PWC) questioned the requirement for the auditor to request management to examine a class of transactions, account balance or disclosure where the auditor evaluates the amount of likely misstatement in that class of transactions, account balance or disclosure as material, either individually or in aggregate with other misstatements (see ED-ISA 320.32). They were also concerned about the related guidance (ED-ISA 320.33). One respondent (FSR) was of the view that management’s correction of likely misstatements should be sufficient since appropriate use of sampling techniques would make the point estimate – the aggregate of known and likely misstatements – the best estimate of the misstatements. Two respondents (HKICPA, PWC) added that management has a choice either to correct the likely misstatements or to do more work with regard to those classes of transactions, account balances or disclosures.
56. On the other hand, one respondent (Deloitte) suggested that it is made clear that it is not sufficient for management to simply correct all the likely misstatements without examining the classes of transactions, account balances or disclosures. Two respondents (DNR, Horwath) were of the view that management should perform the examination, but that the auditor does not have to perform further audit procedures, unless management has disclosed additional information that makes further audit procedures necessary.

Task Force's Recommendation

57. In response to the comments received, the Task Force recommends that ISA XXX establishes requirements and provides guidance on (a) accumulating misstatements identified during the audit (including how they should be categorized), (b) considering accumulated misstatements as the audit progresses, (c) communicating accumulated misstatements to management, and (d) requesting management to correct accumulated misstatements. To avoid confusion, the Task Force is of the view that the term “known misstatement” should not be used. This could be achieved by establishing three categories of misstatements (i.e., factual misstatements, judgmental misstatements, and projected misstatements), and clearly describing each of these categories.

The Accumulation, Including Categorization, of Misstatements [ED-ISA 320.28 and 31]

58. Proposed requirements and guidance on accumulating misstatements identified during the audit are as follows:

Accumulation of Identified Misstatements

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

“Clearly trivial” is not another expression for not material. Matters that are “clearly trivial” will be of a wholly different (smaller) order of magnitude than materiality used in planning and performing the audit, and will be matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances. Further, whenever there is any uncertainty about whether one or more items are “clearly trivial,” the auditor presumes that the matter is not “clearly trivial.” The communication of identified misstatements to management and uncorrected misstatements to those charged with governance need not include misstatements that are clearly trivial.

Misstatements identified during the audit include factual misstatements, judgmental misstatements, and projected misstatements.

- Factual misstatements, for example, include mistakes in gathering or processing data, and the overlooking or clear misinterpretation of facts.
- Judgmental misstatements are differences arising from management’s judgments concerning accounting estimates or the selection or application of accounting policies that the auditor considers unreasonable and inappropriate. The determination of differences arising from management’s judgments 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).”
- Projected misstatements are misstatements that the auditor projects, based on an extrapolation from audit evidence obtained. For example, the amount obtained by projecting misstatements identified in an audit sample to the entire population from which the sample was drawn.

The Consideration of Misstatements as the Audit Progresses [ED-ISA 320.25-27]

59. Proposed requirements and guidance on accumulating misstatements identified during the audit are as follows:

Consideration as the Audit Progresses

The auditor should consider whether the overall audit strategy and audit plan need to be revised if (a) the nature of identified misstatements and the circumstances of their occurrence are indicative that other misstatements may exist that, when aggregated with identified misstatements, could be material, or (b) indicators of possible management bias are present.

The auditor cannot assume that a misstatement is an isolated occurrence. Evidence that other misstatements may exist includes, 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.

Paragraph 94 of ISA 540 contains examples of indicators of possible management bias with respect to accounting estimates that the auditor may identify during the evaluation of audit evidence. The presence of indicators of possible management bias may affect the auditor's conclusion as to whether the auditor's risk assessment remains appropriate. When evidence of other misstatements exist or indicators of possible management bias are present, the auditor considers 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.

If the aggregate of misstatements accumulated during the audit approaches the materiality level, the auditor should consider whether there is a greater than acceptably low level of risk that possible undetected misstatements, when taken with the aggregate of misstatements accumulated during the audit, could exceed the materiality level. If so, the auditor should reconsider the nature, timing and extent of further audit procedures. Undetected misstatements could possibly exist because of the presence of sampling risk (the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population was subjected to the same audit procedure) and non-sampling risk (the risk that the auditor may misinterpret audit evidence and thus not recognize misstatements when they occur).

Communication and Correction of Misstatements [ED-ISA 320.28-34]

60. The Task Force is of the view that the requirements and guidance on communication and correction of misstatements should be retained, i.e.:

The auditor should communicate all misstatements accumulated during the audit to the appropriate level of management on a timely basis.

The auditor should request management to correct all factual misstatements and judgmental misstatements accumulated during the audit. Where the auditor evaluates the amount of projected 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. After management has examined a class of transactions, account balance or disclosure and corrected misstatements that are found, the auditor performs further audit procedures to reevaluate the amount of projected misstatement.

Does the IAASB agree with the Task Force's recommended requirements and guidance on accumulating and categorizing misstatements? Does the IAASB agree with the revised requirements and guidance on considering misstatements as the audit progresses? What is the IAASB's view with regard the communication and request for correction of misstatements?

(J) PRIOR PERIOD UNCORRECTED MISSTATEMENTS (ED-ISA 320.36(c))

61. Several respondents (CNCC, Deloitte, GT, ICAS, KPMG, PWC) identified a need for guidance on the method of evaluating prior period uncorrected misstatements and the effect it has on the auditor's evaluation of current period uncorrected misstatements.

Task Force's Recommendation

62. There are two recognized methods of evaluating prior period uncorrected misstatements – the first method adopts a more “balance sheet view,” (sometimes referred to as the “iron curtain method”) and the other a more “income statement view” (sometimes referred to as the “rollover method”). The Task Force recognizes the merits of both methods, and that both methods are used in practice by auditors. The Task Force does not believe that the IAASB, on its own, can mandate the use of one method over the other. There are significant implications for financial reporting when moving from one method to another, and regulators and investors need to pave the path to transition to make such changes possible. The Task Force therefore recommends that ISA XXX:
- Do not prescribe a method for evaluating prior period uncorrected misstatements, but that it explains the importance of consistently applying the selected method, and
 - Explain that, in evaluating the effect of the current period uncorrected misstatements, the auditor also considers the effect of prior period uncorrected misstatements on the current period financial statements. In doing so, the auditor considers both (a) the adjustment(s) necessary to correct misstatements in the ending balance sheet, even if they arose in whole or part in prior periods, including the effect of the adjustments on the current income statement, and (b) the adjustment(s) necessary to correct misstatements affecting the current income statement.

Does the IAASB agree with the Task Force's recommendation not to prescribe a method for evaluating prior period uncorrected misstatements? Does the IAASB agree with the additional guidance on evaluating the current year and prior period uncorrected misstatements?

(J) MANAGEMENT BIAS (ED-ISA 320.40 (SECOND BULLET))

63. The concept of management bias relating to accounting estimates was first introduced in paragraphs 76(b), 80 and 81 of ISA 240, “The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements.” ED-ISA 540 contained requirements and guidance on the auditor's determination and documentation of misstatements and indicators of possible management bias relating to individual accounting estimates. ED-ISA 320 explained that, during the audit, the auditor is alert for possible bias in management's judgments, since the cumulative effect of a lack of neutrality, together with uncorrected misstatements, may cause the financial statements as a whole to be materially misstated. Although not one respondent opposed including the concept of management bias in ED-ISA 320, and some respondents explicitly supported its inclusion, they raised issues in relation to the proposed guidance.
- Some respondents (HKICPA, ICAEW) were of the view that the concept should be dealt with earlier in the ISA. Two respondents (ICAS, INTOSAI) suggested that it

be addressed in the Nature and Causes of Misstatements section (see ED-ISA 320.4). Two respondents (CEBS, IOSCO) noted that it is an important aspect of determining “planning materiality” and, therefore, should be addressed in the section on Determining Materiality for the Financial Statements as a Whole when Planning the Audit. Another respondent (CICA) suggested that it be included in the circumstances (“qualitative factors”) listed in ED-ISA 320.37.

- A respondent (E&Y) requested more specific guidance on possible management bias in making accounting estimates. This respondent suggested a stronger link to the guidance on indicators of possible management bias in proposed ISA 540. Another respondent (CICA) made a similar comment.
- A respondent (IDW) noted that ED-ISA 320.35 relates to all uncorrected misstatements and, therefore, includes those resulting from possible management bias. ED-ISA 320.39 requires the auditor to “consider both the evaluation of the uncorrected misstatements required in paragraph 35 and the qualitative aspects of the entity’s accounting practices” in evaluating whether the financial statements as a whole are free of material misstatement. Further explanation of the qualitative aspects of the entity’s accounting practices is provided. However, is the auditor not double counting any possible management bias? Especially where estimates appear to the auditor as either over or under cautious?
- A respondent (AICPA) noted that neither ED-ISA 320 nor ED-ISA 540 concludes whether possible management bias is a misstatement. This respondent was of the view that, if indicators of management bias are present, the auditor should undertake sufficient audit procedures to be satisfied that the accounting estimates are neutral and thus free of bias. The auditor uses a neutral estimate for purposes of assessing the reasonableness of management’s estimates and differences, if any, are evaluated as uncorrected misstatements.
- A respondent (GT) was of the view that a separate evaluation of the uncorrected misstatements and the qualitative aspects of the entity’s accounting practices at the end of the engagement is not necessary. Such matters should be discussed in the context of planning and performing the audit and in forming the final opinion, including the analytical procedures performed at or near the end of the engagement, which corroborate the auditor’s conclusions with regard to individual components or elements of the financial statements and assist in arriving at an overall conclusion as to the reasonableness of the financial statements as a whole.
- Two respondents (FEE, IAA) commented on the examples of possible management bias in the second bullet of ED-ISA 320.40 (or referred to their comments on ED-ISA 540 in this regard).

Staff Recommendation²

² This significant comment was developed by staff, in consultation with the Task Force Chair, at the request of the Task Force after the Task Force’s last telephone conference. To ensure the timely posting of the meeting material, the Task Force did not have the opportunity to review the recommendation. The Task Force Chair, however, believes that it is important to obtain the IAASB’s views on this significant comment, and understands that the Task Force may comment on this section during the IAASB meeting.

64. Although proposed ISA 540 explains the concept of possible management bias and the identification of indicators of possible management bias, it presumes that the consideration of indicators of possible management bias during the audit and when evaluating whether the financial statements as a whole are free of material misstatement takes place in ISA XXX. Proposed ISA 540 therefore does not contain requirements or guidance in this regard; it cross refers to the considerations in ISA XXX. Proposed ISA 540 addresses the concept of possible management bias as follows (see Agenda Item 2-B):

Definitions

4(b) “Management bias” – A lack of neutrality by management in the preparation and presentation of information.

Nature of Accounting Estimates

9. Financial reporting frameworks often call for neutrality, that is, freedom from bias. Accounting estimates are, however, imprecise, and are influenced by management judgment. Such judgment may involve unintentional or intentional management bias as a result of motivation to achieve a desired result. The susceptibility of an accounting estimate to management bias increases in relation to the degree of subjectivity of the decisions involved in making the accounting estimate. Unintentional management bias and the potential for intentional management bias are inherent in subjective decisions that are often required in making an accounting estimate.

10. Management bias, whether unintentional or intentional, can be difficult to detect at an account level and may only be identified when considered in the aggregate of groups of estimates or all estimates, or when observed over a number of accounting periods. Although some form of management bias is inherent in subjective decisions, in making such judgments there may be no intention by management to mislead the users of financial statements. Where, however, there is intention to mislead, management bias is fraudulent in nature. ISA 240, “The Auditor’s Responsibility to Consider Fraud in an Audit of Financial Statements,” provides standards and guidance on the auditor’s responsibility to consider fraud in an audit of financial statements.

Risk Assessment Procedures

Reviewing the Outcome or Re-Estimation of Prior Period Accounting Estimates

27. ... by understanding the reasons for any difference between the actual outcome and the prior period’s accounting estimate ... the auditor may obtain ... information indicating possible management bias.

30. The review of the outcome or re-estimation of prior period accounting estimates may assist the auditor in identifying circumstances or conditions that increase the susceptibility of an accounting estimate to, or indicate the presence of, possible management bias. The auditor’s attitude of professional skepticism is an important factor in identifying such circumstance or conditions and in determining the nature, timing and extent of further audit procedures.

Assessment of the Risks of Material Misstatement

33. In assessing the risks of material misstatement, the auditor considers the existence of factors indicating estimation uncertainty, and the degree of susceptibility to bias ...

Responses to the Risks of Material Misstatement

Testing Management’s Process

48. Testing the process used to make the accounting estimate ordinarily involves ... considering whether there are any indicators of possible management bias in the making of the accounting estimates ...

Evaluating Audit Evidence and Concluding on the Reasonableness of the Accounting Estimates

Indicators of Possible Management Bias

92. **The auditor should determine whether there are indicators of possible management bias in the making of accounting estimates.**

93. The auditor considers whether judgments and decisions made by management give rise to indicators of possible management bias. Such indicators of possible management bias do not constitute misstatements for purposes of drawing conclusions on the reasonableness of individual accounting estimates. However, the presence of indicators of possible management bias may affect the auditor's conclusion as to whether the auditor's risk assessment remains appropriate, and the auditor may need to consider implications for the rest of the audit. Further, they may affect the auditor's evaluation of whether the financial statements as a whole are free of material misstatement. ISA XXX ["Aggregating and Evaluating Misstatements"] provides standards and guidance on such considerations.

94. Examples of indicators of possible management bias with respect to accounting estimates that the auditor may identify during the evaluation of audit evidence include:

- Changes in an accounting estimate where management's interpretation and assessment of whether there has been a change in circumstances is subjective.
- Selection or construction of significant assumptions that yield a point estimate favorable for management objectives.
- Selection of a point estimate by management such that the outcome scenario is indicative of a pattern when considered in conjunction with the optimism or pessimism of other accounting estimates.

Documentation

97. **... the auditor should document ... indicators of possible management bias.**

65. The Accounting Estimates Task Force's conclusion that indicators of possible management bias do not constitute misstatements for purposes of drawing conclusions on the reasonableness of individual accounting estimates is supported.

66. Sufficient guidance on possible management bias in making accounting estimates is provided in proposed ISA 540. To strengthen the link between ISA XXX and proposed ISA 540, and respond to requests to address the concept of management bias earlier in ISA XXX, the following text could be inserted in the Nature and Causes of Misstatements section of ISA XXX:

ISA 540, "Auditing Accounting Estimates and related Disclosures (Other Than those Involving Fair Value Measurements and Disclosures)" addresses possible management bias in making accounting estimates. Indicators of possible management bias do not constitute misstatements for purposes of drawing conclusions on the reasonableness of individual accounting estimates. However, the presence of indicators of possible management bias may affect the auditor's conclusion as to whether the auditor's risk assessment remains appropriate, and the auditor may need to consider implications for the rest of the audit *[insert cross reference to ED-ISA 320.25-26 text]*. Further, they may affect the auditor's evaluation of whether the financial statements as a whole are free of material misstatement *[insert cross reference to ED-ISA 320. 39-41 text]*.

67. In line with the above, the following could be considered:

- (a) The Considerations as the Audit Progresses section of ISA XXX (see ED-ISA 320. 25-26) could be revised to refer to the effect of identified indicators of possible

management bias on the overall audit strategy and audit plan. (See paragraph 59 above.)

- (b) ED-ISA 320.41 under the section on Evaluating Whether the Financial Statements as a Whole are Free from Material Misstatement could be revised to require the auditor to discuss with management the auditor's conclusion that the financial statements as a whole are materially misstated, i.e., where this is the case. (ED-ISA 320.41 requires the auditor to request management to make the necessary correction.) The purpose of this discussion is for the auditor to obtain additional information that may, for example, confirm management bias. For example, based on new information, the auditor may be able to narrow the range of reasonable outcomes, leading to management's estimate falling outside the new range of reasonable outcomes and giving rise to a judgmental misstatement.
68. Furthermore, the examples of possible management bias in the second bullet of ED-ISA 320.40 should be amended in line with the revised text in proposed ISA 540.

Does the IAASB agree with Staff's proposed recommendations with regard the guidance on management bias?
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Appendix

List of Respondents

#	Comments By: Member Bodies
1.	American Institute of Certified Public Accountants <i>United States</i>
2.	Association of Chartered Certified Accountants <i>United Kingdom</i>
3.	Canadian Institute of Chartered Accountants <i>Canada</i>
4.	Certified General Accountants Association of Canada <i>Canada</i>
5.	Chartered Institute of Public Finance and Accountancy <i>United Kingdom</i>
6.	Compagnie Nationale des Commissaires aux Comptes – Conseil Supérieur de l'Ordre des Experts-Comptables <i>France</i>
7.	CPA Australia <i>Australia</i>
8.	Den Norske Revisorforening <i>Norway</i>
9.	Foreningen af Statsautoriserede Revisorer <i>Denmark</i>
10.	Foreningen Auktoriserade Revisorer <i>Sweden</i>
11.	Hong Kong Institute of Certified Public Accountants <i>Hong Kong</i>
12.	Institut der Wirtschaftsprüfer <i>Germany</i>
13.	Institut des Réviseurs d'Entreprises <i>Belgium</i>
14.	Institute of Certified Public Accountants of Kenya <i>Kenya</i>
15.	Institute of Certified Public Accountants of Singapore <i>Singapore</i>

16.	Institute of Chartered Accountants of New Zealand <i>New Zealand</i>
17.	Institute of Chartered Accountants of Pakistan <i>Pakistan</i>
18.	Koninklijk Nederlands Instituut van Registeraccountants (Royal NIVRA) <i>The Netherlands</i>
19.	The Institute of Chartered Accountants in Ireland <i>Ireland</i>
20.	The Institute of Chartered Accountants of England and Wales <i>United Kingdom</i>
21.	The Institute of Chartered Accountants of Scotland <i>Scotland</i>
22.	The Institute of Chartered Accountants of Zimbabwe <i>Zimbabwe</i>
23.	The Japanese Institute of Certified Public Accountants <i>Japan</i>
24.	Zambia Institute of Chartered Accountants <i>Zambia</i>

#	Comments By: Firms
1.	Deloitte Touche Tohmatsu <i>United States</i>
2.	Ernst & Young <i>United Kingdom</i>
3.	Grant Thornton International <i>United States</i>
4.	Horwath International <i>United States</i>
5.	KPMG <i>Canada</i>
6.	PKF Accountants & Business Advisors <i>United Kingdom</i>
7.	PricewaterhouseCoopers <i>United Kingdom</i>

#	Comments By: Regulators
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1.	Basel Committee on Banking Supervision <i>Switzerland</i>
2.	Committee of European Banking Supervisors <i>United Kingdom</i>
3.	International Organization of Securities Commissions <i>Spain</i>

#	Comments By: Government Organizations
1.	Australasian Council of Auditors-General
2.	International Organization of Supreme Audit Institutions - Pt 1 <i>Sweden</i>
3.	International Organization of Supreme Audit Institutions - Pt 2 <i>Sweden</i>
4.	Office of the Auditor-General of New Zealand <i>New Zealand</i>
5.	United States Government Accountability Office <i>United States</i>

#	Comments By: Others
1.	Auditing and Assurance Standards Board <i>Australia</i>
2.	Auditing Practices Board <i>United Kingdom</i>
3.	Federation des Experts Comptables Europeens <i>Belgium</i>
4.	Financial Executives International <i>United States</i>
5.	Florida Institute of Certified Public Accountants <i>United States</i>
6.	International Accounting Commission, Association Nationale des Directeurs Financiers et de Controle de Gestion <i>France</i>
7.	International Actuarial Association <i>Canada</i>
8.	Phil Cowperthwaite, CA

	Canada
9.	Public Accountants' and Auditors' Board South Africa