

PREPARED FOR ILLUSTRATIVE PURPOSES ONLY**TEXT IS THE ED-ISA 320 TEXT****NO CHANGES IN RESPONSE TO COMMENTS
HAVE BEEN PROCESSED ON THIS DRAFT****PROPOSED INTERNATIONAL STANDARD ON AUDITING XXX
THE IDENTIFICATION AND EVALUATION OF MISSTATEMENTS**

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

CONTENTS

Paragraph

| | |
|--|--|
| Introduction | |
| Nature and Causes of Misstatements | |
| Considerations 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 of Material Misstatement..... | |
| Evaluating the Overall Effect of Audit Findings on the Auditor's Report | |
| Communications with Those Charged with Governance..... | |
| Documentation | |
| Effective Date..... | |

International Standard on Auditing (ISA) XXX, "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.

Note: The paragraphs numbers in this document relates to the paragraph numbers in the exposure draft.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on identifying and evaluating misstatements when performing an audit of financial statements. ISA 320, “Materiality in Planning and Performing an Audit” establishes standards and provides guidance on the determination of materiality and its application in planning and performing an audit of financial statements.
2. **When planning and performing the audit to reduce audit risk to an acceptably low level, the auditor should consider the risks of material misstatement of the financial statements.**

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.”

Considerations as the Audit Progresses

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.**

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).”

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,² 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

² 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.”

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.

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 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:**

- (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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