



International Federation of Accountants

545 Fifth Avenue, 14th Floor, New York, NY 10017 USA
Tel +1 (212) 286-9344 Fax +1 (212) 286-9570 www.ifac.org

Agenda Item

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Committee: IAASB
Meeting Location: New York
Meeting Date: October 25-27, 2006

Materiality and Misstatements

Objectives of Agenda Item

1. To approve the proposed clarity redrafts of ISA 320 (Revised), “Materiality in the Identification and Evaluation of Misstatements” and ISA 450, “Evaluation of Misstatements Identified during the Audit” for public exposure.

Activities since Last IAASB Discussions

2. The IAASB approved the close off documents of ISA 320 (Revised) and ISA 450 at its May 2006 meeting, and reviewed clarity redrafts of those ISAs at its July 2006 meeting. The Task Force has revised the clarity redrafts based on the comments received from the IAASB.

Matters for Consideration by the IAASB

ISA 450 (Redrafted), Paragraph 8

3. At the July 2006 IAASB meeting, it was suggested that paragraph 8 of ISA 450 (Redrafted) be clarified by way of additional application material. Paragraph 8 requires the auditor to perform further audit procedures to reevaluate the amount of misstatements if management has examined a class of transactions, account balance or disclosure and corrected misstatements that were found. (The equivalent of paragraph 8 in the close off document was written in the present tense.)
4. Although the IAASB had previously agreed that this requirement is not limited to projected misstatements, some members were of the view that it could be explained in the context of projected misstatements.
5. The Task Force has amended the text of paragraph 8, inter alia to indicate that management may examine a class of transactions, account balance or disclosure at the request of the auditor or otherwise. It has also added paragraph A5, which explains that the auditor may request management to examine a class of transactions, account balance or disclosure, for example, based on the auditor’s projection of misstatements identified in an audit sample to the entire population from which it was drawn.
6. **The IAASB is asked to consider whether the proposed amendments address the comment raised at the July 2006 IAASB meeting.**

ISA 450 (Redrafted), Paragraph 11

7. At the July 2006 IAASB meeting, it was noted that the requirement for the auditor to obtain a written representation from management did not align with the requirement for the auditor to communicate with those charged with governance and with the related application material. That is, paragraph 11 of ISA 450 (Redrafted) did not recognize the fact that uncorrected misstatements may be material or that management may not agree that an uncorrected misstatement is in fact a misstatement. Based on a suggestion made during the meeting, the Task Force has amended the paragraph as follows:

“The auditor shall obtain written representation from management ~~that~~ whether it believes the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole ...”

8. The Task Force is concerned that the proposed amendment may change the intention of the requirement in the close off document. **The IAASB is asked for its view in this regard.**

ISA 450 (Redrafted), Paragraph 13

9. Referring to the requirement for the auditor to evaluate the effect of uncorrected misstatements, it was suggested at the July 2006 IAASB meeting that some of the related application material (stated in the present tense in the close off document) be moved to the Requirements section. A small majority of IAASB members were of the view that the requirement should be for the auditor to specifically consider each misstatement separately to evaluate its effect on the relevant classes of transactions, account balances or disclosures, whether it is appropriate to offset misstatements, and the financial effect of classification misstatements.
10. The Task Force found that the brief references to offsetting of misstatements and classification misstatements in the requirement were not helpful as those references need to be read with in the context of the rest of the application material in paragraphs A12-A14. The Task Force therefore proposes not to amend paragraph 13 of ISA 450 (Redrafted). The Task Force has processed minor editorial amendments to paragraphs A12-A14. **Does the IAASB agree with the Task Force’s proposal?**

ISA 450 (Redrafted), Paragraph 14

11. Paragraph 14 of ISA 450 (Redrafted) requires the auditor to consider the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole. Paragraph A17 explains that the cumulative effect of immaterial uncorrected misstatements related to prior periods may have a material effect on the current period’s financial statements, and that there are different acceptable approaches to considering the effect of such misstatements on the current period’s financial statements. It continues to state that, in evaluating the effect of such misstatements on the current period’s financial statements, it is important that the same approach is followed consistently from period to period.
12. At the July 2006 IAASB meeting, it was suggested that the requirement for the auditor to consider the effect of uncorrected misstatements related to prior periods on the current period’s financial statements be expanded to refer to the fact that the auditor should apply the same approach from period to period. The Task Force is of the view that the matter is dealt with

sufficiently in the application material and that it is not necessary to amend the requirement. **Does the IAASB agree with this approach?**

13. On September 13, 2006 the US Securities and Exchange Commission issued Staff Accounting Bulletin No. 108. According to the Bulletin, a registrant has to evaluate the effect of uncorrected misstatements related to prior periods by applying both the “iron curtain” and “rollover” methods. A registrant’s financial statements would require adjustment when either approach results in quantifying a misstatement that is material, after considering all relevant quantitative and qualitative factors.
14. As explained in the material for the May 2006 IAASB meeting, the Task Force remains of the view that the IAASB cannot mandate an approach for the auditor to consider the effect of prior period uncorrected misstatements on the current period’s financial statements. This is because of transitional provisions, which could only be mandated by a regulator or equivalent authority. Although the US SEC has taken a step in this direction, the matter has not been addressed by other national regulators or equivalent authorities. The Task Force therefore is of the view that the requirement in paragraph 14 and application material in paragraph A17 should not be affected by the Bulletin. **Does the IAASB agree with this approach?**

Material Presented

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| Agenda Paper 4-A (Pages 2471 – 2478) | Proposed ISA 320 (Revised and Redrafted), “Materiality in the Identification and Evaluation of Misstatements” (MARK-UP from July 2006 IAASB Draft) |
| Agenda Paper 4-B (Pages 2479 – 2488) | Proposed ISA 450 (Redrafted), “Evaluation of Misstatements Identified during the Audit” (MARK-UP from July 2006 IAASB Draft) |
| Agenda Paper 4-C (Pages 2489 – 2498) | ISA 320: Mapping Document |
| Agenda Paper 4-D (Pages 2499 - 2510) | ISA 450: Mapping Document |

Action Requested

15. The IAASB is asked to consider the matters highlighted in this paper, and approve ISA 320 (Revised and Redrafted) and ISA 450 (Redrafted) for public exposure.

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