Materiality and Misstatements

Objective of Agenda Item
1. To approve as final standards proposed ISA 320 (Revised and Redrafted), “Materiality in Planning and Performing an Audit” and proposed ISA 450 (Revised and Redrafted), “Evaluation of Misstatements Identified during the Audit.”

Task Force Composition
2. The Task Force members are:
   - Denise Esdon – Chair, IAASB Deputy Chair
   - Jon Grant – IAASB Member
   - Diana Hillier – IAASB Member

Activities since Last IAASB discussions
3. As noted at the March IAASB meeting, significant comments received on the exposure draft were discussed at the March 3-4, 2008 IAASB Consultative Advisory Group (CAG) meeting. The IAASB CAG Representatives did not have significant comments on the matters highlighted for their consideration.

4. At the March IAASB meeting, the Task Force was asked to: (a) clarify that performance materiality is an amount or amounts set at less than materiality for the financial statements as a whole and, if applicable, it also refers to the amount or amounts set at less than the materiality level or levels for particular classes of transactions, account balances or disclosures; and (b) to amend paragraph A12 (see Agenda Item 9-A) by deleting the example and explaining that the determination of performance materiality is also affected by the auditor’s expectations in relation to misstatements in the current period.

5. Subsequent to the March IAASB meeting, the IAASB was asked to review the proposed changes to the ISAs in response to the matters noted above, in advance of this meeting. Twelve responses were received. Respondents were supportive of the changes processed in response to the comments raised at the March IAASB meeting, with the exception of the proposed example that had been designed to illustrate when more than one amount of performance materiality may be set for an audit. Some respondents found the proposed example confusing and were concerned that it goes beyond application of the clarity conventions. Respondents did
not indicate any remaining issues that may keep them from voting the document at this meeting.

6. The proposed ISAs in Agenda Items 9-A and 9-B show in marked text the changes that the Task Force is proposing to the March IAASB meeting drafts. Those changes take into account the comments received from the respondents subsequent to the March IAASB meeting. Although the respondents commented on various matters, the Task Force limited the changes to those that affected the text that was revised subsequent to the March IAASB meeting. As the proposed ISAs were discussed in detail by the IAASB, the Task Force did not consider it appropriate to change text that was not subjected to discussion at the March IAASB meeting, except for one issue raised in relation to written representations, as explained below.

Matters for Consideration by the IAASB

WRITTEN REPRESENTATIONS

7. As indicated in the correspondence with the IAASB, an issue relating to the timing of the written representation required by ISA 450 (Revised and Redrafted) and the date of written representations required by ISA 580 (Revised and Redrafted) was raised subsequent to the March 2008 meeting. The issue is explained below.

8. ISA 450 (Revised and Redrafted) – discussed at the March IAASB meeting – requires the auditor to communicate misstatements accumulated during the audit with management; to request management to correct all such misstatements; and to obtain a written representation from management about the uncorrected misstatements.

9. ISA 450 (Revised and Redrafted) also requires the auditor to communicate uncorrected misstatements with those charged with governance; to include the written representation from management about uncorrected misstatements in such communication; and to request those charged with governance to correct uncorrected misstatements.

10. ISA 580 (Revised and Redrafted) requires the auditor to obtain the written representations as near as practicable to, but not after, the date of the auditor’s report.

11. The requirement to include the written representation from management about uncorrected misstatements in the communication with those charged with governance could be interpreted as requiring such written representation at the time the communication with those charged with governance occurs; and again at a date as near as practicable to, but not after, the date of the auditor’s report (i.e., in compliance with ISA 580 (Revised and Redrafted)) if time has elapsed since the first representation was obtained or if any corrections were made by those charged with governance.

12. The intent of ISA 450 (Revised and Redrafted) was not to request a written representation from management about uncorrected misstatements at two different times during the audit.

13. The Task Force proposes that this issue be addressed by moving the requirement to obtain a written representation from management about uncorrected misstatements to follow the requirement to communicate uncorrected misstatements with those charged with governance, and by deleting the requirement that the communication with those charged with governance includes such written representation. The written representation will therefore deal with the
misstatements remaining after corrections by management and, if applicable, those charged with governance and can be obtained as near as practicable to, but not after, the date of the auditor’s report.

14. This proposal was reflected in the ISA 450 (Revised and Redrafted) that was distributed to the IAASB subsequent to the March IAASB meeting. The respondents supported the proposal. See paragraphs 14 and A24 of Agenda Item 9-B.

REFERENCE TO THE DIFFERENT LEVELS OF MATERIALITY

15. ISA 450 (Revised and Redrafted) contains various references to “materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures).” These references are to materiality determined in accordance with paragraph 10 of ISA 320 (Revised and Redrafted), which may be revised as the audit progresses in accordance with paragraphs 12-13 of ISA 320 (Revised and Redrafted).

16. To simplify the ISAs and improve their readability, the Task Force proposes that such references be replaced with “materiality determined in accordance with ISA 320 (Revised and Redrafted).”

CONFORMING AMENDMENTS

17. During the March IAASB meeting, staff was asked to determine whether the requirement for the auditor to determine materiality for the financial statements as a whole; if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures; and performance materiality may affect the references to materiality in other ISAs.

18. Staff has reviewed the redrafted (and revised and redrafted) ISAs approved by the IAASB to identify all references to materiality. The Appendix contains a proposal with regard to conforming amendments.

CONSIDERATION OF THE NEED TO RE-EXPOSE

19. Agenda Items 9-C and 9-D show in marked text the changes processed to the exposure draft. The Task Force is of the view that the changes are in response to matters raised by respondents to the exposure draft. They do not introduce new principles or represent other changes of substances when compared with the exposure draft. Accordingly, the Task Force is of the view that re-exposure is not necessary.¹

20. The proposed IAASB Strategy and Work Program, 2009-2011 indicates that the IAASB may consider developing further certain key conceptual matters, including materiality. This was also recommended by some of the respondents to the exposure draft and may assist in

¹ IAASB Working Procedures regarding re-exposure state: “Situations that constitute potential grounds for a decision to re-expose may include, for example: substantial change to a proposal arising from matters not aired in the exposure draft such that commentators have not had an opportunity to make their views known to the IAASB before it reaches a final conclusion; substantial change arising from matters not previously deliberated by the IAASB; or substantial change to the substance of an International Standard or Practice Statement.”
addressing some of the detailed comments raised by IAASB members and others during discussion of the proposed ISAs.

Material Presented

Agenda Item 9-A ISA 320 (Revised and Redrafted) – Marked up from March 14 IAASB Draft
(Pages 1077 - 1086)

Agenda Item 9-B ISA 450 (Revised and Redrafted) – Marked up from March 14 IAASB Draft
(Page 1087 - 1098)

Agenda Item 9-C ISA 320 (Revised and Redrafted) – Marked up from Exposure Draft
(Page 1099 - 1108)

Agenda Item 9-D ISA 450 (Revised and Redrafted) – Marked up from Exposure Draft
(Pages 1109 - 1122)

Action Requested

The IAASB is asked to approve:

1. Proposed ISA 320 (Revised and Redrafted) and proposed ISA 450 (Revised and Redrafted) as final standards.
2. Conforming amendments as outlined in the Appendix.
### Extracts from Final Redrafted ISAs – Proposed Conforming Amendments

<table>
<thead>
<tr>
<th>Section</th>
<th>Description</th>
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<tbody>
<tr>
<td>230.A17</td>
<td>… Examples of matters that may be documented together in the audit of a smaller entity include the understanding of the entity and its internal control, the overall audit strategy and audit plan, materiality determined in accordance with ISA 320 (Revised and Redrafted), assessed risks, significant matters noted during the audit, and conclusions reached.</td>
</tr>
<tr>
<td>240.A36</td>
<td>Incorporating an element of unpredictability in the selection of the nature, timing and extent of audit procedures to be performed is important as individuals within the entity who are familiar with the audit procedures normally performed on engagements may be more able to conceal fraudulent financial reporting. This can be achieved by, for example: Performing substantive procedures on selected account balances and assertions not otherwise tested due to their materiality or risk …</td>
</tr>
<tr>
<td>250.A3</td>
<td>… Detection of non-compliance, regardless of materiality, may affect other aspects of the audit including, for example, the auditor’s consideration of the integrity of management or employees.</td>
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</table>
| 240.Appendix 1 | **Examples of Risk Factors**  
**Risk Factors Relating to Misstatements Arising from Fraudulent Financial Reporting**  
The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting.  
*Attitudes / Rationalizations*  
- Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality. | No conforming amendment proposed. Reference is to materiality for accounting / financial reporting purposes. |
| 260.A15 | Communication regarding the planned scope and timing of the audit may: (a) Assist those charged with governance to understand better the consequences of the auditor’s work, to discuss issues of risk and the concept of materiality with the auditor, and to identify any areas in which may request the auditor to undertake additional procedures … | See proposed conforming amendment in marked text. |
| 260.A17 | Matters communicated may include: … The application of the concept of materiality in the context of an audit. | See proposed conforming amendment in marked text. |
| 300.A3 | … For example, planning includes the need to consider, prior to the auditor’s identification and assessment of the risks of material misstatement, such matters as:  
- The analytical procedures to be applied as risk assessment procedures.  
- Obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying | No conforming amendment proposed. It is proposed that the reference to “in accordance with ISA 320 (Revised and Redrafted)” be omitted in this case as |

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### Considerations in Establishing the Overall Audit Strategy

**Significant Factors, Preliminary Engagement Activities, and Knowledge Gained on Other Engagements**

- The determination of appropriate materiality levels in accordance with ISA 320 (Revised and Redrafted), and, where applicable, including:
  - Setting materiality for planning purposes.
  - Setting materiality for components and communicating materiality for thereof to component auditors of components in accordance with ISA 600 (Revised and Redrafted).
  - Reconsidering materiality as audit procedures are performed during the course of the audit.
  - Preliminary identification of significant components and material classes of transactions, account balances and disclosures.

### Obtaining an Understanding of the Entity and its Environment

- Establishing and determining materiality in accordance with ISA 320 (Revised and Redrafted), and evaluating whether the judgment about materiality remains appropriate as the audit progresses.

### Factors Relevant to the Auditor's Judgment

- Materiality.
- ...
<table>
<thead>
<tr>
<th>Paragraph</th>
<th>Text</th>
<th>Amendment</th>
</tr>
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<tbody>
<tr>
<td>540.A94</td>
<td>Ordinarily, a range that has been narrowed to be equal to or less than the amount lower than the materiality level for the financial statements as a whole determined for purposes of assessing risks of material misstatement, and designing further audit procedures performance materiality is adequate for the purposes of evaluating the reasonableness of management’s point estimate.</td>
<td>See proposed conforming amendment in marked text.</td>
</tr>
<tr>
<td>540.A122</td>
<td>… The auditor’s evaluation of the adequacy of disclosure of estimation uncertainty increases in importance the greater the range of possible outcomes of the accounting estimate is in relation to materiality (see related discussion in paragraph A95).</td>
<td>See proposed conforming amendment in marked text.</td>
</tr>
<tr>
<td>540.A126</td>
<td>ISA 580 (Revised and Redrafted) discusses the use of written representations. Depending on the nature, materiality and extent of estimation uncertainty, written representations about accounting estimates recognized or disclosed in the financial statements may include representations …</td>
<td>No conforming amendment proposed.</td>
</tr>
<tr>
<td>550.A46</td>
<td>Materiality Considerations in Evaluating Misstatements [Proposed] ISA 450 (Revised and Redrafted) requires the auditor to consider both the size and the nature of a misstatement, and the particular circumstances of its occurrence, when evaluating whether the misstatement is material. The significance of the transaction to the financial statement users may not depend solely on the recorded amount of the transaction but also on other specific relevant factors, such as the nature of the related party relationship.</td>
<td>No conforming amendment proposed.</td>
</tr>
<tr>
<td>600.9(d)</td>
<td>Component materiality – The materiality level for a component determined by the group engagement team.</td>
<td>See proposed conforming amendments in marked text.</td>
</tr>
<tr>
<td>600.21-23</td>
<td>Materiality 21. The group engagement team shall determine the following: (Ref: Para. A42) (a) The materiality level for the group financial statements as a whole when establishing the overall group audit strategy. (b) Whether, in the specific circumstances of the group, there are particular classes of transactions, account balances or disclosures in the group financial statements for which misstatements of lesser amounts than the materiality level for the group financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the group financial statements. In such circumstances, the group engagement team shall determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures. (c) Component materiality for those components where component auditors will perform an audit or a review for purposes of the group audit. To reduce to an...</td>
<td>See proposed conforming amendments in marked text.</td>
</tr>
</tbody>
</table>
appropriately low level the risk probability that the aggregate total of detected uncorrected and undetected misstatements in the group financial statements exceeds the materiality level for the group financial statements as a whole, component materiality shall be lower than the materiality level for the group financial statements as a whole. (Ref: Para. A43-A44)

(d) The threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements. (Ref: Para. A45)

22. Where component auditors will perform an audit for purposes of the group audit, the group engagement team shall evaluate the appropriateness of the amount or amounts lower than the component materiality level (and the amount or amounts lower than the materiality level for particular classes of transactions, account balances or disclosures, if applicable) performance materiality determined for purposes of assessing the risks of material misstatement and designing further audit procedures to respond to assessed risks at the component level. (Ref: Para. A46)

23. When a component is subject to audit by statute, regulation or other reason, and the group engagement team decides to use that audit to provide audit evidence for the group audit, the group engagement team shall determine whether:

(a) the materiality level determined for the component financial statements as a whole; and

(b) the lower amounts determined for purposes of assessing the risks of material misstatement and designing further audit procedures to respond to assessed risks performance materiality at the component level meet the requirements of this ISA.

600.26-27

26. For a component that is significant due to its individual financial significance to the group, the group engagement team, or a component auditor on its behalf, shall perform an audit of the financial information of the component using component materiality.

27. For a component that is significant because it is likely to include significant risks of material misstatement of the group financial statements due to its specific nature or circumstances, the group engagement team, or a component auditor on its behalf, shall perform one or more of the following:

(a) An audit of the financial information of the component using component materiality.

(b) An audit of one or more account balances, classes of transactions or disclosures relating to the likely significant risks of material misstatement of the group financial statements. (Ref: Para. A48)

(c) Specified audit procedures relating to the likely significant risks of material misstatement of the group

No conforming amendment proposed.
| 600.29 | 29. If the group engagement team does not consider that sufficient appropriate audit evidence on which to base the group audit opinion will be obtained from:  
(a) the work performed on the financial information of significant components;  
(b) the work performed on group-wide controls and the consolidation process; and  
(c) the analytical procedures performed at group level, the group engagement team shall select components that are not significant components and shall perform, or request a component auditor to perform, one or more of the following on the financial information of the individual components selected: (Ref: Para. A51-A53)  
- An audit of the financial information of the component using component materiality.  
- An audit of one or more account balances, classes of transactions or disclosures.  
- A review of the financial information of the component using component materiality.  
- Specified procedures.  
The group engagement team shall vary the selection of components over a period of time. | No conforming amendment proposed. |
| 600.40(c) | 40. The group engagement team shall communicate its requirements to the component auditor on a timely basis. This communication … shall also include the following:  
(a) …  
(b) …  
(c) In the case of an audit or review of the financial information of the component, component materiality (and, if applicable, the amount or amounts lower than the materiality level or levels for particular classes of transactions, account balances or disclosures, if applicable) and the threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements.  
(d) … | See proposed conforming amendments in marked text. |
| 600.A42-A46 | **Materiality** (Ref: Para. 21-23)  
A42. The auditor is required:  
(a) When establishing the overall audit strategy:  
   i. To determine a materiality level for the financial statements as a whole; and  
   ii. When establishing the overall audit strategy, to consider whether, if, in the specific circumstances of the entity, there are particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than the materiality | See proposed conforming amendments in marked text. |
level for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. In such circumstances, the auditor, to determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures; and

(eb) To determine one or more amounts lower than the materiality level for the financial statements as a whole for purposes of assessing the risks of material misstatement and designing further audit procedures to respond to assessed risks performance materiality.

In the context of a group audit, materiality levels are established for both the group financial statements as a whole, and for the financial information of the components. The materiality level for the group financial statements as a whole is used when establishing the overall group audit strategy.

A43. To reduce to an appropriately low level the risk probability that the aggregate total of detected uncorrected and undetected misstatements in the group financial statements exceeds the materiality level for the group financial statements as a whole, the component materiality level is set lower than the group materiality level for the group financial statements as a whole. Different component materiality levels may be established for different components. The component materiality level need not be an arithmetical portion of the group materiality level for the group financial statements as a whole and, consequently, the aggregate of the component materiality levels for the different components may exceed the group materiality level for the group financial statements as a whole. The component materiality level is used when establishing the overall audit strategy for a component.

A44. Component materiality levels are determined for those components whose financial information will be audited or reviewed as part of the group audit in accordance with paragraphs 26, 27(a) and 29. Component materiality is used by the component auditor to evaluate whether uncorrected detected misstatements are material, individually or in the aggregate.

A45. A threshold for misstatements is determined in addition to the component materiality levels. Misstatements identified in the financial information of the component that are above the threshold for misstatements are communicated to the group engagement team.

A46. In the case of an audit of the financial information of a component, the component auditor (or group engagement team) determines one or more amounts lower than the component materiality level performance materiality for purposes of assessing the risks of material misstatement of the financial information of the component and to design further audit procedures in response to assessed risks at the component level. This is necessary to reduce to an appropriately low level the
risk, probability that the aggregate total of detected and undetected misstatements in the financial information of the component exceeds the component materiality level. In practice, the group engagement team may set component materiality at this lower level. Where this is the case, the component auditor uses component materiality for purposes of assessing the risks of material misstatement of the financial information of the component and to design further audit procedures in response to assessed risks as well as for evaluating whether detected misstatements are material individually or in the aggregate.

### Required and Additional Matters Included in the Group Engagement Team’s Letter of Instruction

Matters required by this ISA to be communicated to the component auditor are shown in italicized text.
Matters that are relevant to the planning of the work of the component auditor:

- In the case of an audit or review of the financial information of the component, component materiality (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures), and the threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements.

See proposed conforming amendment in marked text.
The proposed amendment aligns the bullet point with the requirement in 600.40(c).