Basis for Conclusions:
ISA 320 (Revised and Redrafted), Materiality in Planning and Performing an Audit and
ISA 450 (Revised and Redrafted), Evaluation of Misstatements Identified during the Audit

Prepared by the Staff of the International Auditing and Assurance Standards Board
This Basis for Conclusions has been prepared by staff of the International Auditing and Assurance Standards Board (IAASB). It relates to, but does not form part of, ISA 320 (Revised and Redrafted), “Materiality in Planning and Performing an Audit,” and ISA 450 (Revised and Redrafted), “Evaluation of Misstatements Identified during the Audit,” which were approved by the IAASB in June 2008.1

Background

1. In December 2004, the IAASB issued an exposure draft of proposed ISA 320 (Revised).2 The comment period for the proposed ISA closed on April 30, 2005. The IAASB gave due consideration to the comments received and approved “close off” documents of ISA 320 (Revised)3 and ISA 450 (Revised)4 in the “old style” (i.e., following the extant ISA’s drafting conventions for ISAs) in May 2006.5 The IAASB’s Clarity conventions were applied to those documents. An exposure draft of proposed ISA 320 (Revised and Redrafted) and proposed ISA 450 (Revised and Redrafted) was published in October 2006.

2. The Clarity conventions used by the IAASB in redrafting its ISAs, and the authority and obligation attaching to those conventions, are established in ISA 200 (Revised and Redrafted), “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing.”6

3. The comment date for the exposure draft was February 15, 2007. The IAASB received 46 comment letters from a variety of respondents, including IFAC member bodies, national standard setters, firms, regulators, government organizations, and others. Input was also received from IFAC’s Small and Medium Practices Committee. The IAASB revised the proposed ISAs as a result of these comments. The following summarizes the more significant issues raised by respondents, and how the IAASB addressed them.

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1 See minutes of the June 16-20, 2008 IAASB meeting at http://www.ifac.org/IAASB/Meeting-FileDL.php?FID=4272.
2 Proposed ISA 320 (Revised), “Materiality in the Identification and Evaluation of Misstatements.”
3 Close off document of ISA 320 (Revised), “Materiality in Planning and Performing an Audit.”
4 Close off document of ISA 450 (Revised), “Evaluation of Misstatements Identified during the Audit.”
5 The Basis for Conclusions: ISA 320 (Revised) and ISA 450 (Revised) and related close off documents are available on the IAASB website at http://www.ifac.org/Guidance/EXD-Details.php?EDID=0062.
6 ISA 200 (Revised and Redrafted), which was approved by the IAASB in June 2008 for submission to the Public Interest Oversight Board for its confirmation of due process, contains the final statement of the authority and obligation attaching to the Clarity conventions.
Proposed ISA 320 (Revised and Redrafted) (ED-ISA 320)

Objective

4. ED-ISA 320 contained the following objective: “The objective of the auditor is to determine, and reconsider as the audit progresses, an appropriate materiality level or levels to enable the auditor to plan and perform the audit.”

5. Many respondents were supportive of the objective. Some respondents suggested that the objective be amended to indicate that it may be necessary to revise the materiality level or levels as the audit progresses; rather than stating that “the objective of the auditor is to … reconsider as the audit progresses, an appropriate materiality level or levels …” The IAASB was concerned that this proposal would make the objective process oriented, while some respondents noted that the objective could be more outcomes oriented. The IAASB amended the objective as follows to make it more outcomes oriented: “The objective of the auditor is to apply the concept of materiality appropriately in planning and performing the audit.” See paragraph 8 of ISA 320 (Revised and Redrafted).

Terminology

6. ED-ISA 320 required the auditor to determine the following:

   (a) A materiality level for the financial statements as a whole.

   (b) A materiality level or levels to be applied to particular classes of transactions, account balances or disclosures 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 level for the financial statements as a whole could reasonably be expected to influence the economic decision of users taken on the basis of the financial statements.

   (c) An amount or amounts lower than the materiality level for the financial statements as a whole (and, if applicable, an amount or amounts lower than the materiality level or levels for particular classes of transactions, account balances or disclosures) for purposes of assessing the risks of material misstatement and designing further audit procedures to respond to assessed risks.

7. The responses to ED-ISA 320 indicated that respondents might not have clearly understood the different levels of materiality. Furthermore, the IAASB was concerned that references to “materiality level or levels” in ED-ISA 320 and other ISAs may not be understood as including (a) and (b) above.

8. The phrase “amount or amounts lower than the materiality level or levels for purposes of assessing the risks of material misstatement and designing further audit procedures to respond to assessed risks” ((c) above) was also used in other ISAs. During IAASB discussions it became clear that the phrase may be confusing when used without the context provided by ISA 320 (Revised and Redrafted).

9. The IAASB agreed that ED-ISA 320 (and the other ISAs) should be amended so that it is clear that the auditor will always determine a materiality level for the financial statements
as a whole; however, the auditor may conclude that it is not necessary to determine a materiality level or levels to be applied to particular classes of transactions, account balances or disclosures. The IAASB also agreed that a term should be identified to be used in place of the description in (c) above. As a result:

(a) ED-ISA 320 was amended to indicate that the determination of materiality level or levels for particular classes of transactions, account balances or disclosures is only required if, in the specific circumstances of the entity, there are one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality 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. See paragraph 10 of ISA 320 (Revised and Redrafted).

(b) The ISAs refer to “materiality for the financial statements as a whole” in the case of paragraph 6(a) above, and “materiality level or levels for particular classes of transactions, account balances or disclosures” in the case of 6(b) above.

(c) The term “performance materiality” was added to the ISAs. It is defined as follows: “The amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.”

10. To simplify the ISAs and improve their readability, the other ISAs will be amended to refer to “materiality determined in accordance with ISA 320 (Revised and Redrafted)” and “performance materiality,” as appropriate.

Performance Materiality

11. An IAASB member was concerned that it may not be clear from the text of ISA 320 (Revised and Redrafted) that performance materiality may be more than one amount. While the intention of the IAASB was to clarify the concept of performance materiality by identifying and defining the term, the intention was not to reduce it to one amount only. As a result, the definition of “performance materiality” and paragraph A12 of ISA 320 (Revised and Redrafted) were amended to clearly indicate that it can be one or more amounts, and that it relates to materiality for the financial statements as whole and to the materiality level or levels for particular classes of transactions, account balances or disclosures.

12. Concern was also expressed that the example in paragraph A13 of ED-ISA 320 may not be helpful. In the example, performance materiality for an entity with a history of large or numerous misstatements accumulated in previous audits would be lower than if such misstatements were not present. An IAASB member was of the view that performance materiality might well be unaffected by prior period misstatements, while other IAASB members pointed out that performance materiality may be affected not only by the prior
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year misstatements but also by the auditor’s expectation of misstatements in the current period. The IAASB agreed to delete the example and clarify the matter in the paragraph. See paragraph A12 of ISA 320 (Revised and Redrafted).

Proposed ISA 450 (Revised and Redrafted) (ED-ISA 450)

Forming an Opinion on the Financial Statements

13. In redrafting ISA 700 (Amended),⁷ the IAASB considered how the requirements and guidance in ED-ISA 450 that dealt with the evaluation of whether the financial statements as a whole are free from material misstatement relate to the requirements and guidance in ISA 700 (Amended) that deal with forming an opinion on the financial statements.

14. The IAASB concluded that, in light of the definition of a “misstatement” in ED-ISA 450, there was not a clear differentiation between the consideration of the “qualitative aspects of the entity’s accounting practices” in ED-ISA 450 and the matters that the auditor is asked to evaluate in forming an opinion on the financial statements in ISA 700 (Amended). The IAASB agreed that the overlap should be addressed by transferring the requirements and guidance in ED-ISA 450 that dealt with the evaluation of whether the financial statements as a whole are free from material misstatement and the consideration of management bias to proposed ISA 700 (Redrafted),⁸ and amending the objective of ED-ISA 450 accordingly.

15. As a result, ISA 450 (Revised and Redrafted) deals with the evaluation of the effect of uncorrected misstatements, while proposed ISA 700 (Redrafted) deals with the evaluation whether the financial statements as a whole are free from material misstatement.

Objective

16. ED-ISA 450 contained the following objective: “The objective of the auditor is to evaluate: (a) the effect of identified misstatements on the audit; and (b) the effect of uncorrected misstatements on the financial statements and whether the financial statements as a whole are free from material misstatement.”

17. Many respondents were supportive of the objective; although some suggested refinement. Some respondents’ comments, however, were addressed by or became irrelevant due to the move of requirements and guidance to ED-ISA 700 (Redrafted) (see paragraphs 13-15 above).

18. The IAASB amended the objective as explained in paragraph 14 above. The revised objective is as follows: “The objective of the auditor is to evaluate: (a) the effect of identified misstatements on the audit; and (b) the effect of uncorrected misstatements, if any, on the financial statements.” See paragraph 3 of ISA 450 (Revised and Redrafted).

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⁷ ISA 700 (amended as a result of the close off document of ISA 800 (Revised), “Special Considerations—Audits of Special Purpose Financial Statements and Specific Elements, Accounts or Items of a Financial Statement”), “The Independent Auditor’s Report on General Purpose Financial Statements.”

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Deletion of the Requirement to Distinguish between Factual, Judgmental and Projected Misstatements

19. ED-ISA 450 required the auditor to accumulate misstatements identified during the audit, other than those that are clearly trivial, distinguishing between factual misstatements, judgmental misstatements and projected misstatements. Many respondents did not support this requirement. Some respondents were of the view that the text in the close off document of ISA 450 (Revised) clearly was guidance as it stated that such distinction is useful to assist the auditor in considering the effects of misstatements accumulated during the audit and in communicating them to management and those charged with governance. Some respondents were of the view that the requirement served no practical purpose, since the auditor is required to request management to correct all misstatements. Furthermore, the distinction was not used in the evaluation of the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements.

20. In response, the IAASB:
   (a) Deleted the reference to the distinction between factual, judgmental and projected misstatements in the requirement for the auditor to accumulate misstatements identified during the audit (see paragraph 5 of ISA 450 (Revised and Redrafted));
   (b) Deleted the reference to the distinction between factual, judgmental and projected misstatements in the requirement for the auditor to document all misstatements accumulated during the audit (see paragraph 15(b) of ISA 450 (Revised and Redrafted));
   (c) Explained in the application material that a distinction between factual, judgmental and projected misstatements may assist the auditor in evaluating the effects of misstatements accumulated during the audit, and in communicating misstatements to management and those charged with governance (see paragraph A3 of ISA 450 (Revised and Redrafted)); and
   (d) Moved the definitions of the terms “factual misstatement,” “judgmental misstatement,” and “projected misstatement” to the application material as the terms were no longer used in the Requirements section (see paragraph A3 of ISA 450 (Revised and Redrafted)).

Deletion of Requirement relating to Communication with Those Charged with Governance

21. Paragraph 15 of ED-ISA 450 required the auditor to communicate uncorrected misstatements and their effect on the auditor’s opinion to those charged with governance. Paragraph 16 of ED-ISA 450 required the auditor to communicate with those charged with governance the reasons for, and the implications of, a failure to correct misstatements, having regard to the size and nature of the misstatement judged in the surrounding circumstances, including possible implications in relation to future financial statements. This requirement was based on a present tense statement in the close off document of ISA 450 (Revised); that is, “The auditor discusses with those charged with governance the reasons for…”
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22. Some respondents did not support the requirement proposed in paragraph 16 of ED-ISA 450.

(a) Some respondents were concerned that the elevation of the present tense statement confused the principles in the original guidance. They noted that the close off document described matters that the auditor would discuss with those charged with governance about those uncorrected misstatements that the auditor is required to communicate to them. The requirement in paragraph 16 of ED-ISA 450, however, was not linked to the requirement to communicate the uncorrected misstatements and, therefore, may imply that there are two different communication responsibilities. They were of the view that, rather than a dialogue about the uncorrected misstatements, paragraph 16 could result in a standard “boilerplate” communication about the implications of failing to correct misstatements.

(b) Some respondents were concerned that the wording of paragraph 16 of ED-ISA 450 may imply that it is the auditor’s responsibility to explain the reasons why management has not corrected a misstatement, when such explanations ought to be sought by those charged with governance from management.

23. In response, the IAASB moved the text of paragraph 16 of ED-ISA 450, appropriately amended, to the application material, as guidance on the requirement of paragraph 12 for the auditor to communicate uncorrected misstatements with those charged with governance and the effect that they may have on the opinion in the auditor’s report. See paragraph A23 of ISA 450 (Revised and Redrafted).

Written Representations

24. ED-ISA 450 required 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 that it believes the uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. It also required 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.

25. ISA 580 (Revised and Redrafted)9 requires the auditor to obtain the written representations as near as practicable to, but not after, the date of the auditor’s report.

26. Concern was expressed that 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 of that communication; 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. The IAASB agreed that the intention was not to request a written representation in such circumstances.

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9 ISA 580 (Revised and Redrafted), “Written Representations.”
representation from management about uncorrected misstatements at two different times during the audit.

27. The IAASB addressed this issue by moving the requirement to obtain a written representation from management about uncorrected misstatement 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 include 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. See paragraph 14 of ISA 450 (Revised and Redrafted).