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

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International Federation
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BASIS FOR CONCLUSIONS:
ISA 320 (REVISED), MATERIALITY IN PLANNING AND PERFORMING AN AUDIT
AND
ISA 450, EVALUATION OF MISSTATEMENTS IDENTIFIED DURING THE AUDIT

This Basis for Conclusions has been prepared by staff of the International Auditing and Assurance Standards Board (IAASB) and has not been discussed by the IAASB. It does not form part of ISA 320 (Revised) or ISA 450.

Background

1. The IAASB approved a project to revise extant ISA 320, "Audit Materiality," in June 2002. Since the issuance of extant ISA 320 in 1994, several national standard setters have revised and expanded their requirements and guidance, in particular, to recognize the need for greater consideration of the nature of an item and of the circumstances of the entity when determining materiality and evaluating misstatements. In addition, work undertaken by the Auditing Practices Board in the United Kingdom on aggressive earnings management highlighted materiality as an important consideration in dealing with that issue.

2. The IAASB issued an exposure draft of proposed ISA 320 (Revised) ("ED-ISA 320") in December 2004, with a comment date of April 30, 2005. The IAASB received forty-eight comment letters from a variety of respondents, including regulators, IFAC member bodies, and firms. The IAASB revised ED-ISA 320 as a result of these comments. The following summarizes the more significant issues raised by respondents, and how the IAASB addressed them.

An ISA for Materiality and a Separate ISA for Misstatements

3. The IAASB attributed many of the comments on ED-ISA 320 to the fact that respondents were confused by the flow of the document. It was not clear to some respondents that ED-ISA 320 provided for materiality to be determined at the planning stage of the audit; considered throughout the audit and, if necessary, adjusted; and ultimately used to evaluate misstatements identified during the audit. Nor was it clear that the communication of misstatements with management is not a discrete phase of the audit, but rather a continual and iterative process.

4. The IAASB concluded that the clarity and flow of the requirements and guidance would be enhanced by addressing materiality and misstatements in separate ISAs; that is, an ISA on materiality in planning and performing an audit ("ISA 320 (Revised)") and an ISA on evaluating misstatements identified during the audit ("ISA 450").

Special Purpose Audit Engagements

5. Paragraph 1 of ED-ISA 320 stated that the requirements and guidance were to be adapted for audits of historical financial information other than financial statements. Some

respondents noted that this statement was not helpful and requested additional guidance on the application of the requirements to special purpose audit engagements.

6. The IAASB considered this general issue separately in the context of the revision of extant ISA 800, "The Auditor's Report on Special Purpose Audit Engagements." It concluded that considerations specific to special purpose audit engagements should not be incorporated into the individual ISAs, but should be dealt with in the revised ISA 800. While there are arguments in each direction, the IAASB considered that this would prevent over-complicating certain ISAs by the need to include material that is not of general application. It would also assist those standard setters and jurisdictions adopting the ISAs for general purpose audits.

Management's Materiality

7. ED-ISA 320 did not make any reference to management's materiality. Some respondents were of the view that the auditor, when determining materiality for the audit, should consider the materiality that management has determined for financial reporting purposes. They were of the view that inappropriate determination of materiality, or its incorrect application, on the part of management represents a risk that may cause the financial statements to be materially misstated.

8. The IAASB was concerned that an explicit requirement in ISA 320 (Revised) for the auditor to obtain an understanding of management's determination of materiality may be interpreted as the auditor substituting management's judgment for his or her own responsibility to determine materiality for the audit. The IAASB recognized that management implicitly considers materiality in a number of circumstances. For example, a concept of "tolerance" is used when designing and implementing systems of internal control to ensure complete and accurate financial reporting and to prevent or detect and correct misstatements (such as when determining an amount or percentage for exception reports, or when establishing approval limits). Management also implicitly uses 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. However, the IAASB was of the view that management normally does not have a formal process for determining materiality 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).

9. As part of the auditor's risk assessment procedures required by ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," the auditor will necessarily 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. ISA 315 therefore accomplishes the consideration that some respondents thought important.

10. The IAASB therefore concluded that it would not be necessary to include additional requirements and guidance in ISA 320 (Revised) or to amend ISA 315.

Materiality in the Context of an Audit (Paragraphs 4-8 of ISA 320 (Revised))

Definition of Materiality

11. The definition of materiality in ED-ISA 320 was taken from International Accounting Standard (IAS) 1, "Presentation of Financial Statements." Some respondents suggested that the IAASB develop a stand-alone definition for materiality in the context of an audit, while some respondents were of the view that the auditor should use the definition of materiality in the applicable financial reporting framework to determine materiality for the audit.

12. The IAASB accepted that the applicable financial reporting framework may define materiality, and that such definition may differ from that in ED-ISA 320, and that at some future date the International Accounting Standards Board may amend its definition. The IAASB concluded that it would be more appropriate to describe the characteristics of materiality often discussed in financial reporting frameworks, and to indicate that, should such a discussion of materiality exist in the applicable financial reporting framework, it would provide a frame of reference to the auditor in determining materiality for the audit. If the applicable financial reporting framework, however, does not include a discussion of materiality, the characteristics described in ISA 320 (Revised) provide the auditor with such a frame of reference.

Users of Financial Statements

13. Paragraph 8 of ED-ISA 320 explained that the evaluation of whether a misstatement could influence economic decisions of users, and so be material, involves consideration of the characteristics of those users, and listed such characteristics. Many respondents expressed concern about this guidance.

14. The purpose of the guidance 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 IAASB considered it useful to provide guidance on the context in which users make decisions.

The Qualitative Aspects of Materiality

15. Many respondents identified the need for more prominent guidance on the qualitative aspects of materiality. Respondents referred to the examples in paragraph 37 of ED-ISA 320, 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.

16. 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.

Paragraph 8 of ISA 320 (Revised) explains that the circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are below the materiality level or levels. Although it is not practicable to design audit procedures to detect misstatements that could be material solely because of their nature, the auditor nevertheless is alert for such misstatements when performing the audit.

Percentages of Benchmarks (Paragraph 15 of ISA 320 (Revised))

17. Paragraph 14 of ED-ISA 320 contained illustrative examples of percentages that could be applied to chosen benchmarks. Many respondents questioned whether it was advisable to include such examples in the revised ISA. They were concerned that such "rules of thumb" would become the "standard;" the examples gave undue emphasis to the quantitative aspects of materiality; 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.

18. The IAASB accepted these points and amended the text to be less prescriptive. It also agreed that the remaining guidance should be in the application material when the new clarity drafting conventions are applied to the revised ISA.

Tolerable Error (Paragraphs 19 and 20 of ISA 320 (Revised))

19. Paragraph 20 of ED-ISA 320 required the auditor to determine one or more levels of tolerable error for classes of transactions, account balances and disclosures. The purpose of the requirement was for the auditor, in performing risk assessments and further audit procedures, to allow for the possibility that the aggregate of individually immaterial misstatements could be material. However, reference to the term "tolerable error" created confusion and led to requests for additional guidance on the approach to be followed in determining tolerable error.

20. The IAASB concluded that it would not be possible to promote a single approach for determining tolerable error because it is not aware of any persuasive evidence to support one approach over the others, or to suggest that the quality of audits is directly affected by the approach used. To eliminate confusion, however, the IAASB revised the guidance in ISA 320 (Revised) to explain the concept in general terms (i.e., without reference to the term "tolerable error").

Categorization, Communication and Correction of Misstatements

21. Paragraph 31 of ED-ISA 320 categorized misstatements as known misstatements (separately identifying misstatements of fact and misstatements involving subjective decisions), and likely misstatements. Many respondents were of the view that the categorization of misstatements should be revised. Most of them were concerned about categorizing misstatements involving subjective decisions as a subset of known misstatements. 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 cannot be known for a fact.

22. Some respondents were of the view that paragraph 32 of ED-ISA 320 drew an arbitrary line by requiring auditors to request correction of all known misstatements (including misstatements involving subjective decisions), while any suggestion of further investigation by management is limited to likely misstatements. They were of the view that, 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).

23. Some respondents 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 paragraph 32 of ED-ISA 320). They were also concerned about the related guidance in paragraph 33 of ED-ISA 320, which explained that, 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.

24. The IAASB decided to retain misstatements involving subjective decisions, but as a separate category referred to as judgmental misstatements. The IAASB was of the view that even though such misstatements involve subjective decisions, they are the auditor's view of what are misstatements. They therefore have to be communicated to management with a request that they be corrected. In response to the comments received, the related requirements and guidance (moved to ISA 450) were revised as follows:

- Under the heading Accumulation of Identified Misstatements, ISA 450:
    - Requires the auditor to accumulate misstatements identified during the audit, other than those that are clearly trivial (paragraph 5), and
    - Explains that, 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, it is useful to distinguish between factual misstatements, judgmental misstatements and projected misstatements (paragraph 7).
- Under the heading Considerations as the Audit Progresses, ISA 450 explains that it may be necessary for management to examine a class of transactions, account balance or disclosure to identify and correct misstatements therein (paragraph 10). This paragraph also notes that, after management has examined a class of transactions, account balance or disclosure and corrected misstatements that were found, the auditor performs further audit procedures to reevaluate the amount of misstatements.

Prior Period Uncorrected Misstatements (Paragraph 26 of ISA 450)

25. Paragraph 36(c) of ED-ISA 320 stated that, before considering the aggregate effect of identified uncorrected misstatements, the auditor considers each misstatement separately to evaluate the effect of prior period uncorrected misstatements. Several respondents noted 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.

26. There are different acceptable approaches to the evaluation of prior period uncorrected misstatements – for example, one approach 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 IAASB recognized that both approaches are applied in practice by auditors. The IAASB did not believe that, on its own, it could mandate the use of one approach over the other, because of the potential significant implications relating to a change in approach. However, these implications are expected to diminish over time as auditors will be required by ISA 450 to request that management correct all misstatements accumulated during the audit.

27. In response to the comments received, the related guidance moved to ISA 450 was revised to explain that:

    - The correction by management of all misstatements communicated by the auditor assists management in maintaining accurate accounting books and records and reduces the risks of material misstatement of financial statements because of the cumulative effect of immaterial uncorrected misstatements related to prior periods (paragraph 14).

    - The auditor also considers, and communicates with those charged with governance, 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. The cumulative effect of immaterial uncorrected misstatements related to prior periods may have a material effect on the current period's financial statements. There are different acceptable approaches to this consideration. Whichever approach is followed by the auditor, it is important that it be followed consistently from period to period. (Paragraph 26)

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