

IAASB CAG PAPER



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Agenda Item

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Committee: IAASB Consultative Advisory Group

Meeting Location: Paris

Meeting Date: May 11-12, 2006

Report Back—Materiality and Misstatements

Objectives of Agenda Item

1. To provide a brief report back on the November 30-December 1, 2005 proposals of Representatives on proposed ISA 320 (Revised), “Materiality in Planning and Performing and Audit” and proposed ISA 450, “Evaluation of Misstatements Identified during the Audit,” and on significant matters discussed at the December 2005 IAASB meeting.
2. At the May 2006 IAASB meeting, the IAASB will be asked to approve the “close off” versions of proposed ISA 320 (Revised) and proposed ISA 450. Time permitting, the IAASB will also review the “clarity” versions of the proposed ISAs.

November 30-December 1, 2005 CAG Proposals

Below is an extract from the minutes of the November 30-December 1, 2005 CAG meeting minutes¹ and an indication of how the IAASB Task Force or the IAASB responded to the Representatives’ comments.

Representatives’ comments	IAASB task force/IAASB response
Proposed ISA 320 (Revised)	
Some Representatives questioned the need to describe materiality in the context of an audit. They were of the view that the definition in IAS 1, “Presentation of Financial Statements” should be used. It was noted, however, that the proposed description is in line with the IAS 1 definition. It was suggested that the proposed description be moved to precede paragraph 8 of proposed ISA 320.	Recognizing that the applicable financial reporting framework may not define materiality or may provide a definition that differs now or may differ at a later date from that in proposed ISA 320 (Revised) (that is, should such a definition be included), the Task Force concluded that the comments would be best addressed by describing the elements of materiality often discussed in financial reporting frameworks, and by indicating that, should such a discussion of materiality exist in the financial reporting framework, it provides a frame of reference to the auditor in determining materiality level or levels for the audit. If the applicable financial

¹ The minutes will be approved at the May 11-12, 2006 IAASB CAG meeting.

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	<p>reporting framework, however, does not include a discussion of materiality, the elements described in proposed ISA 320 (Revised) provide the auditor with such a frame of reference. Refer to paragraphs 4-6 of proposed ISA 320 (Revised) (Agenda Item G.1).</p> <p>The Task Force recommends that the explanation of materiality in the context of an audit follow the Introduction section of proposed ISA 320 (Revised and Redrafted). Although it may be argued that the Materiality in the Context of an Audit section is long (even longer than the Requirements section), the Task Force is of the view that this section is important and necessary for the requirements to be understood in that context.</p>
<p>Some Representatives were of the view that proposed ISA 320 (Revised) should include reference to materiality determined by management of an entity and how it affects the auditor's determination of materiality. Ms. Singh was of the view that the auditor should not determine materiality, but that he or she should use management's materiality. Mr. Popham added that the determination of materiality is a matter for the auditor but that some recognition of management responsibility for the correctness of the financial statements is important. Ms. Esdon noted that the IAASB will consider a paper containing the Task Force's recommendation regarding management's materiality. The Task Force is of the view that, although not explicitly stated, ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement" sufficiently addresses the auditor's understanding of management's materiality. (The IAASB paper can be accessed at: http://www.ifac.org/IAASB/Meeting-BGPapers.php?MID=0040&ViewCat=0448. Click on "Agenda Item 6-E – Materiality – Management's Materiality.")</p>	<p>After discussion at the December 2005 IAASB meeting, the IAASB concluded that a number of paragraphs in the requirements and application material of ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," contain implicit references to management's materiality and that it was not necessary to include an explicit reference in proposed ISA 320 or to amend ISA 315 to include such a reference.</p>
<p>Mr. Morris was of the view that proposed ISA 320 (Revised) should not include examples of percentages</p>	<p>The Task Force is of the view that the guidance on benchmarks and percentages will enhance the</p>

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Representatives' comments	IAASB task force/IAASB response
<p>that could be applied to chosen benchmarks. Mr. Popham was of the view that, when redrafted based on the clarity drafting conventions, examples of percentages, if any, should be in the application material.</p>	<p>consistent application of the proposed requirements. In December 2005, the IAASB agreed that the examples should be retained. However, recognizing the concerns of respondents to the ED and of the CAG representatives, the IAASB agreed that the text should be amended to be less prescriptive, and the guidance should be in the application material of the redrafted ISA. The Task Force revised the text in line with the comments received. Refer to paragraph 15 of proposed ISA 320 (Revised) (Agenda Item G.1).</p>
<p>Proposed ISA 450</p>	
<p>Mr. Popham referred to the reference in the definition of misstatement to disclosures that, in the auditor's judgment, is otherwise necessary for the fair presentation of the financial statements. He noted that this assumes the auditor is expressing an opinion on the fair presentation of the financial statements, which may not be the case. Mr. Sekiguchi shared this view, referring to possible practical confusion due to the ambiguity of this definition.</p>	<p>The Task Force revised the definition of misstatement to ensure that it is not limited to financial reporting frameworks designed to achieve fair presentation. Refer to paragraph 3 of proposed ISA 450 (Agenda Item G.2).</p> <p>The Task Force also reviewed the remainder of the proposed ISA to ensure that it applies to all financial reporting frameworks.</p>
<p>With regard to prior period uncorrected misstatements, Mr. Popham was of the view that the proposed ISA should provide for a fourth category of misstatements, i.e., misstatements as a result of the improper application of an accounting policy that may become material in the future.</p>	<p>The IAASB did not think that this suggestion would be practicable, as there are many matters that could become material in future, but are immaterial for the audit in question.</p>

Other Matters – Proposed ISA 320 (Revised)

TOLERABLE ERROR

In the draft considered by the IAASB in December 2005, the Task Force had expanded the guidance on tolerable error to explain the concept in general terms, without referring to the term “tolerable error.” The IAASB concluded that it was important that the concept remained in the proposed revised ISA 320; however, it did not need to be explained beyond what the Task Force had proposed.

Other Matters – Proposed ISA 450

MISSTATEMENTS

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The IAASB asked the Task Force to clarify the link between materiality determined for planning and performing the audit and materiality used to evaluate uncorrected misstatements. The split of the exposure draft into two documents might have created the impression that the auditor determines planning materiality and evaluation materiality. The link between “planning materiality” and “evaluation materiality” was strengthened. **Refer to paragraphs 7- 8 of proposed ISA 320 (Revised) (Agenda Item G.1), and paragraphs 21-23 of proposed ISA 450 (Agenda Item G.2).**

PRIOR PERIOD UNCORRECTED MISSTATEMENTS

The IAASB asked the Task Force to further consider the guidance on prior period uncorrected misstatements. The Task Force remains of the view that the IAASB cannot mandate one approach for the auditor to account for prior period uncorrected misstatements because of transitional provisions which could only be mandated by a regulator or equivalent authority. Proposed ISA 450 requires the auditor to request management to correct all misstatements. The existence of prior period uncorrected misstatements should therefore diminish over time.

To provide for the current situation, the proposed guidance has been revised to explain that the cumulative effect of immaterial uncorrected misstatements related to prior periods may have a material effect on the current period’s financial statements. Consequently, the auditor’s consideration may take account of the effect of such misstatements on the ending balance sheet, or on the current period’s income statement and balance sheet, or both. It is not possible to prescribe an approach; however, it is important that the auditor applies the selected approach consistently from period to period. **Refer to paragraph 26 of proposed ISA 450 (Agenda Item G.2).**

Material Presented – FOR REFERENCE PURPOSES ONLY

Agenda Item G.1	Proposed ISA 320 (Revised), “Materiality in Planning and Performing an Audit” (May 2006 IAASB Agenda Item X-A)
Agenda Item G.2	Proposed ISA 450, “Evaluation of Misstatements Identified during the Audit” (May 2006 IAASB Agenda Item X-B)
Agenda Item G.3	Proposed ISA 320 (Revised and Redrafted), “Materiality in Planning and Performing an Audit” (May 2006 IAASB Agenda Item X-C)
Agenda Item G.4	Proposed ISA 450 (Redrafted), “Evaluation of Misstatements Identified during the Audit” (May 2006 IAASB Agenda Item X-D)

The remainder of the May 2006 IAASB meeting material is available from <http://www.ifac.org/IAASB/Meeting-BGPapers.php?MID=0065>.