

# ISSAI 1450

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## INTOSAI



*Financial Audit Guideline*

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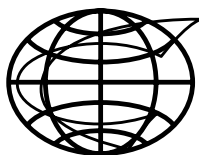
# *Evaluation of Misstatements Identified during the Audit*

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*This Financial Audit Guideline draws on International Standard on Auditing (ISA) 450 “Evaluation of Misstatements Identified during the Audit” developed by the International Auditing and Assurance Standards Board (IAASB) and published by the International Federation of Accountants (IFAC). The ISA is included in this Guideline with the permission of IFAC.*

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*Practice Note<sup>1</sup> to International Standard on Auditing (ISA) 450*

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# Evaluation of Misstatements Identified during the Audit

## Background

This Practice Note provides supplementary guidance on ISA 450 – Evaluation of Misstatements Identified during the Audit. It is read together with the ISA. ISA 450 is effective for audits of financial statements for periods beginning on or after December 15, 2009. The Practice Note is effective the same date as the ISA.

## Introduction to the ISA

ISA 450 deals with the auditor's responsibility to evaluate the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements. ISA 700<sup>2</sup> deals with the auditor's responsibility, in forming an opinion on the financial statements, to conclude whether reasonable assurance has been obtained about whether the financial statements as a whole are free from material misstatement. The auditor's conclusion required by ISA 700 takes into account the auditor's evaluation of uncorrected misstatements, if any, on the financial statements, in accordance with ISA 450. ISA 320<sup>3</sup> deals with the auditor's responsibility to apply the concept of materiality appropriately in planning and performing an audit of financial statements.

## Content of the Practice Note

- P1. The Practice Note provides additional guidance for public sector auditors related to:
- (a) Overall Considerations.
  - (b) Evaluating the Effect of Uncorrected Misstatements.
  - (c) Written Representations.
  - (d) Specific Considerations for Public Sector Auditors with a Judicial Role.

## Applicability of the ISA in Public Sector Auditing

- P2. ISA 450 is applicable to auditors of public sector entities in their role as auditors of the financial statements.

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<sup>1</sup> All Practice Notes are considered together with ISSAI 1000, "General Introduction to the INTOSAI Financial Audit Guidelines."

<sup>2</sup> ISA 700, "Forming an Opinion and Reporting on Financial Statements," paragraphs 10-11.

<sup>3</sup> ISA 320, "Materiality in Planning and Performing an Audit."

## Additional Guidance on Public Sector Issues

- P3. ISA 450 contains application and other explanatory material with considerations specific to public sector entities in paragraphs A19 and A20 of the ISA.

## Overall Considerations

- P4. The objectives of a financial audit in the public sector are often broader than expressing an opinion whether the financial statements have been prepared, in all material respects, in accordance with the applicable financial reporting framework (i.e. the scope of the ISAs). The objectives may include additional auditing and reporting responsibilities, for example, relating to reporting whether the auditor found any instances of non-compliance with authorities including budgets and accountability frameworks and/or reporting on the effectiveness of internal control. In addition to evaluating misstatements, public sector auditors may also evaluate instances of non-compliance with authorities and report on the effectiveness of internal control. When public sector auditors have such additional reporting responsibilities, each reporting responsibility is evaluated separately.

## Evaluating the Effect of Uncorrected Misstatements

- P5. In applying paragraph 11 of the ISA public sector auditors with additional reporting responsibilities related to non-compliance with authorities and control deficiencies separately evaluate each of these objectives. However, misstatements, instances of non-compliance with authorities and control deficiencies can be interrelated, potentially increasing the risk to each objective.
- P6. Paragraphs 12 to 13 of the ISA deal with communication of uncorrected misstatements with those charged with governance. Where appropriate to the public sector auditors' mandate this communication may include instances of non-compliance with authorities and control deficiencies. Public sector auditors may also need to communicate misstatements, instances of non-compliance with authorities and control deficiencies to additional parties such as government officials.
- P7. When communicating with those charged with governance or with additional parties as described in paragraph P6 above, public sector auditors may be expected to communicate all misstatements, even those that have been corrected by the entity. When communicating with those charged with governance, public sector auditors use ways of reporting relevant to their environment. Public sector auditors may also be called upon to testify before the legislature on the results of the financial statement audit.

## Written Representation

- P8. Paragraph 14 of the ISA requires the auditor to obtain written representation that management considers the effects of uncorrected misstatements on the financial statements to be immaterial. Where public sector auditors have additional responsibilities for compliance with authorities and effectiveness of internal control these representations may be made in a single document.

## Specific Considerations for Public Sector Auditors with a Judicial Role

- P9. In some public sector audit environments, such as in a Court of Accounts environment, the auditors' report is often used to determine personal legal implications of those responsible for financial acts, including significant matters, instances of non-compliance with authorities, and control deficiencies. Therefore, public sector auditors in such environments, when evaluating the misstatements, instances of non-compliance with authorities and control deficiencies identified during the audit, also identify those responsible for the financial acts and for compliance with legal requirements.
- P10. Paragraph 8 of the ISA requires the auditor to communicate on a timely basis all misstatements accumulated during the audit with the appropriate level of management. Where public sector auditors have mandates which include the legal authority to order the entity to correct any misstatements as well as instances of non-compliance with authorities, they consider whether exercising this authority may impair their independence and, if so, take appropriate action to avoid such impairment.



*International Standard on Auditing*

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# Evaluation of Misstatements Identified during the Audit



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# INTERNATIONAL STANDARD ON AUDITING 450

## EVALUATION OF MISSTATEMENTS IDENTIFIED DURING THE AUDIT

(Effective for audits of financial statements for periods  
beginning on or after December 15, 2009)

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International Standard on Auditing (ISA) 450, “Evaluation of Misstatements Identified during the Audit” should be read in the context of ISA 200, “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing.”

## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibility to evaluate the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements. ISA 700 deals with the auditor's responsibility, in forming an opinion on the financial statements, to conclude whether reasonable assurance has been obtained about whether the financial statements as a whole are free from material misstatement. The auditor's conclusion required by ISA 700 takes into account the auditor's evaluation of uncorrected misstatements, if any, on the financial statements, in accordance with this ISA.<sup>1</sup> ISA 320<sup>2</sup> deals with the auditor's responsibility to apply the concept of materiality appropriately in planning and performing an audit of financial statements.

### Effective Date

2. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2009.

### Objective

3. 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.

### Definitions

4. For purposes of the ISAs, the following terms have the meanings attributed below:
  - (a) **Misstatement** – A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud. (Ref: Para. A1)  
  
When the auditor expresses an opinion on whether the financial statements are presented fairly, in all material respects, or give a true and fair view, misstatements also include those adjustments of amounts,

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<sup>1</sup> ISA 700, "Forming an Opinion and Reporting on Financial Statements," paragraphs 10-11.

<sup>2</sup> ISA 320, "Materiality in Planning and Performing an Audit."

classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the financial statements to be presented fairly, in all material respects, or to give a true and fair view.

- (b) Uncorrected misstatements – Misstatements that the auditor has accumulated during the audit and that have not been corrected.

## Requirements

### Accumulation of Identified Misstatements

- 5. The auditor shall accumulate misstatements identified during the audit, other than those that are clearly trivial. (Ref: Para. A2-A3)

### Consideration of Identified Misstatements as the Audit Progresses

- 6. The auditor shall determine whether the overall audit strategy and audit plan need to be revised if:
  - (a) The nature of identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that, when aggregated with misstatements accumulated during the audit, could be material; or (Ref: Para. A4)
  - (b) The aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with ISA 320. (Ref: Para. A5)
- 7. If, at the auditor's request, management has examined a class of transactions, account balance or disclosure and corrected misstatements that were detected, the auditor shall perform additional audit procedures to determine whether misstatements remain. (Ref: Para. A6)

### Communication and Correction of Misstatements

- 8. The auditor shall communicate on a timely basis all misstatements accumulated during the audit with the appropriate level of management, unless prohibited by law or regulation.<sup>3</sup> The auditor shall request management to correct those misstatements. (Ref: Para. A7-A9)
- 9. If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor shall obtain an understanding of management's reasons for not making the corrections and shall take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement. (Ref: Para. A10)

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<sup>3</sup> ISA 260, "Communication with Those Charged with Governance," paragraph 7.

### **Evaluating the Effect of Uncorrected Misstatements**

10. Prior to evaluating the effect of uncorrected misstatements, the auditor shall reassess materiality determined in accordance with ISA 320 to confirm whether it remains appropriate in the context of the entity's actual financial results. (Ref: Para. A11-A12)
11. The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. In making this determination, the auditor shall consider:
  - (a) The size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence; and (Ref: Para. A13-A17, A19-A20)
  - (b) 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. (Ref: Para. A18)

### *Communication with Those Charged with Governance*

12. The auditor shall communicate with those charged with governance uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report, unless prohibited by law or regulation.<sup>4</sup> The auditor's communication shall identify material uncorrected misstatements individually. The auditor shall request that uncorrected misstatements be corrected. (Ref: Para. A21-A23)
13. The auditor shall also communicate 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.

### **Written Representation**

14. The auditor shall request a written representation from management and, where appropriate, those charged with governance whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. A summary of such items shall be included in or attached to the written representation. (Ref: Para. A24)

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<sup>4</sup> See footnote 3.

## Documentation

15. The auditor shall include in the audit documentation:<sup>5</sup> (Ref: Para. A25)
- (a) The amount below which misstatements would be regarded as clearly trivial (paragraph 5);
  - (b) All misstatements accumulated during the audit and whether they have been corrected (paragraphs 5, 8 and 12); and
  - (c) The auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion (paragraph 11).

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## Application and Other Explanatory Material

### Definition of Misstatement (Ref: Para. 4(a))

- A1. Misstatements may result from:
- (a) An inaccuracy in gathering or processing data from which the financial statements are prepared;
  - (b) An omission of an amount or disclosure;
  - (c) An incorrect accounting estimate arising from overlooking, or clear misinterpretation of, facts; and
  - (d) Judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection and application of accounting policies that the auditor considers inappropriate.

Examples of misstatements arising from fraud are provided in ISA 240.<sup>6</sup>

### Accumulation of Identified Misstatements (Ref: Para. 5)

- A2. The auditor may designate an amount below which misstatements would be clearly trivial and would not need to be accumulated because the auditor expects that the accumulation of such amounts clearly would not have a material effect on the financial statements. "Clearly trivial" is not another expression for "not material." Matters that are clearly trivial will be of a wholly different (smaller) order of magnitude than materiality determined in

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<sup>5</sup> ISA 230, "Audit Documentation," paragraphs 8-11, and paragraph A6.

<sup>6</sup> ISA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements," paragraphs A1-A6.

accordance with ISA 320, and will be matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances. When there is any uncertainty about whether one or more items are clearly trivial, the matter is considered not to be clearly trivial.

- A3. To assist the auditor in evaluating the effect of misstatements accumulated during the audit and in communicating misstatements to management and those charged with governance, it may be useful to distinguish between factual misstatements, judgmental misstatements and projected misstatements.
- Factual misstatements are misstatements about which there is no doubt.
  - Judgmental misstatements are differences arising from the judgments of management concerning accounting estimates that the auditor considers unreasonable, or the selection or application of accounting policies that the auditor considers inappropriate.
  - Projected misstatements are the auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn. Guidance on the determination of projected misstatements and evaluation of the results is set out in ISA 530.<sup>7</sup>

#### **Consideration of Identified Misstatements as the Audit Progresses (Ref: Para. 6-7)**

- A4. A misstatement may not be an isolated occurrence. Evidence that other misstatements may exist include, for example, where the auditor identifies that a misstatement arose from a breakdown in internal control or from inappropriate assumptions or valuation methods that have been widely applied by the entity.
- A5. If the aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with ISA 320, there may be a greater than acceptably low level of risk that possible undetected misstatements, when taken with the aggregate of misstatements accumulated during the audit, could exceed materiality. Undetected misstatements could exist because of the presence of sampling risk and non-sampling risk.<sup>8</sup>
- A6. The auditor may request management to examine a class of transactions, account balance or disclosure in order for management to understand the cause of a misstatement identified by the auditor, perform procedures to determine the amount of the actual misstatement in the class of transactions, account balance or disclosure, and to make appropriate adjustments to the financial

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<sup>7</sup> ISA 530, "Audit Sampling," paragraphs 14-15.

<sup>8</sup> ISA 530, paragraph 5(c)-(d).

statements. Such a request may be made, for example, based on the auditor's projection of misstatements identified in an audit sample to the entire population from which it was drawn.

#### **Communication and Correction of Misstatements (Ref: Para. 8-9)**

- A7. Timely communication of misstatements to the appropriate level of management is important as it enables management to evaluate whether the items are misstatements, inform the auditor if it disagrees, and take action as necessary. Ordinarily, the appropriate level of management is the one that has responsibility and authority to evaluate the misstatements and to take the necessary action.
- A8. Law or regulation may restrict the auditor's communication of certain misstatements to management, or others, within the entity. For example, laws or regulations may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act. In some circumstances, potential conflicts between the auditor's obligations of confidentiality and obligations to communicate may be complex. In such cases, the auditor may consider seeking legal advice.
- A9. The correction by management of all misstatements, including those communicated by the auditor, enables management to maintain accurate accounting books and records and reduces the risks of material misstatement of future financial statements because of the cumulative effect of immaterial uncorrected misstatements related to prior periods.
- A10. ISA 700 requires the auditor to evaluate whether the financial statements are prepared and presented, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation includes consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments,<sup>9</sup> which may be affected by the auditor's understanding of management's reasons for not making the corrections.

#### **Evaluating the Effect of Uncorrected Misstatements (Ref: Para. 10-11)**

- A11. The auditor's determination of materiality in accordance with ISA 320 is often based on estimates of the entity's financial results, because the actual financial results may not yet be known. Therefore, prior to the auditor's evaluation of the effect of uncorrected misstatements, it may be necessary to revise materiality determined in accordance with ISA 320 based on the actual financial results.

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<sup>9</sup> ISA 700, paragraph 12.

- A12. ISA 320 explains that, as the audit progresses, 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) is revised in the event of the auditor becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially.<sup>10</sup> Thus, any significant revision is likely to have been made before the auditor evaluates the effect of uncorrected misstatements. However, if the auditor's reassessment of materiality determined in accordance with ISA 320 (see paragraph 10 of this ISA) gives rise to a lower amount (or amounts), then performance materiality and the appropriateness of the nature, timing and extent of the further audit procedures are reconsidered so as to obtain sufficient appropriate audit evidence on which to base the audit opinion.
- A13. Each individual misstatement is considered to evaluate its effect on the relevant classes of transactions, account balances or disclosures, including whether the materiality level for that particular class of transactions, account balance or disclosure, if any, has been exceeded.
- A14. If an individual misstatement is judged to be material, it is unlikely that it can be offset by other misstatements. For example, if revenue has been materially overstated, the financial statements as a whole will be materially misstated, even if the effect of the misstatement on earnings is completely offset by an equivalent overstatement of expenses. It may be appropriate to offset misstatements within the same account balance or class of transactions; however, the risk that further undetected misstatements may exist is considered before concluding that offsetting even immaterial misstatements is appropriate.<sup>11</sup>
- A15. Determining whether a classification misstatement is material involves the evaluation of qualitative considerations, such as the effect of the classification misstatement on debt or other contractual covenants, the effect on individual line items or sub-totals, or the effect on key ratios. There may be circumstances where the auditor concludes that a classification misstatement is not material in the context of the financial statements as a whole, even though it may exceed the materiality level or levels applied in evaluating other misstatements. For example, a misclassification between balance sheet line items may not be considered material in the context of the financial statements as a whole when the amount of the misclassification is small in relation to the size of the related balance sheet line items and the misclassification does not affect the income statement or any key ratios.

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<sup>10</sup> ISA 320, paragraph 12.

<sup>11</sup> The identification of a number of immaterial misstatements within the same account balance or class of transactions may require the auditor to reassess the risk of material misstatement for that account balance or class of transactions.

A16. The circumstances related to some misstatements may cause the auditor to evaluate them as material, individually or when considered together with other misstatements accumulated during the audit, even if they are lower than materiality for the financial statements as a whole. Circumstances that may affect the evaluation include the extent to which the misstatement:

- Affects compliance with regulatory requirements;
- Affects compliance with debt covenants or other contractual requirements;
- Relates to the incorrect selection or application of an accounting policy that has an immaterial effect on the current period's financial statements but is likely to have a material effect on future periods' financial statements;
- Masks a change in earnings or other trends, especially in the context of general economic and industry conditions;
- Affects ratios used to evaluate the entity's financial position, results of operations or cash flows;
- Affects segment information presented in the financial statements (for example, the significance of the matter to a segment or other portion of the entity's business that has been identified as playing a significant role in the entity's operations or profitability);
- Has the effect of increasing management compensation, for example, by ensuring that the requirements for the award of bonuses or other incentives are satisfied;
- Is significant having regard to the auditor's understanding of known previous communications to users, for example, in relation to forecast earnings;
- Relates to items involving particular parties (for example, whether external parties to the transaction are related to members of the entity's management);
- Is an omission of information not specifically required by the applicable financial reporting framework but which, in the judgment of the auditor, is important to the users' understanding of the financial position, financial performance or cash flows of the entity; or
- Affects other information that will be communicated in documents containing the audited financial statements (for example, information to be included in a "Management Discussion and Analysis" or an "Operating and Financial Review") that may reasonably be expected to

influence the economic decisions of the users of the financial statements. ISA 720<sup>12</sup> deals with the auditor's consideration of other information, on which the auditor has no obligation to report, in documents containing audited financial statements.

These circumstances are only examples; not all are likely to be present in all audits nor is the list necessarily complete. The existence of any circumstances such as these does not necessarily lead to a conclusion that the misstatement is material.

- A17. ISA 240<sup>13</sup> explains how the implications of a misstatement that is, or may be, the result of fraud ought to be considered in relation to other aspects of the audit, even if the size of the misstatement is not material in relation to the financial statements.
- A18. 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 the auditor's evaluation of such uncorrected misstatements on the current period's financial statements. Using the same evaluation approach provides consistency from period to period.

#### *Considerations Specific to Public Sector Entities*

- A19. In the case of an audit of a public sector entity, the evaluation whether a misstatement is material may also be affected by the auditor's responsibilities established by law, regulation or other authority to report specific matters, including, for example, fraud.
- A20. Furthermore, issues such as public interest, accountability, probity and ensuring effective legislative oversight, in particular, may affect the assessment whether an item is material by virtue of its nature. This is particularly so for items that relate to compliance with law, regulation or other authority.

#### *Communication with Those Charged with Governance (Ref: Para. 12)*

- A21. If uncorrected misstatements have been communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, they need not be communicated again with those same person(s) in their governance role. The auditor nonetheless has to be satisfied that communication with person(s) with management responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity.<sup>14</sup>

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<sup>12</sup> ISA 720, "The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements."

<sup>13</sup> ISA 240, paragraph 35.

<sup>14</sup> ISA 260, paragraph 13.

- A22. Where there is a large number of individual immaterial uncorrected misstatements, the auditor may communicate the number and overall monetary effect of the uncorrected misstatements, rather than the details of each individual uncorrected misstatement.
- A23. ISA 260 requires the auditor to communicate with those charged with governance the written representations the auditor is requesting (see paragraph 14 of this ISA).<sup>15</sup> The auditor may discuss 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, and possible implications in relation to future financial statements.

**Written Representation** (Ref: Para. 14)

- A24. Because the preparation of the financial statements requires management and, where appropriate, those charged with governance to adjust the financial statements to correct material misstatements, the auditor is required to request them to provide a written representation about uncorrected misstatements. In some circumstances, management and, where appropriate, those charged with governance may not believe that certain uncorrected misstatements are misstatements. For that reason, they may want to add to their written representation words such as: “We do not agree that items ... and ... constitute misstatements because [description of reasons].” Obtaining this representation does not, however, relieve the auditor of the need to form a conclusion on the effect of uncorrected misstatements.

**Documentation** (Ref: Para. 15)

- A25. The auditor’s documentation of uncorrected misstatements may take into account:
- (a) The consideration of the aggregate effect of uncorrected misstatements;
  - (b) The evaluation of whether the materiality level or levels for particular classes of transactions, account balances or disclosures, if any, have been exceeded; and
  - (c) The evaluation of the effect of uncorrected misstatements on key ratios or trends, and compliance with legal, regulatory and contractual requirements (for example, debt covenants).

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<sup>15</sup> ISA 260, paragraph 16(c)(ii).