KAEG-I [INTL VERSION 2024]: ISA 450 Evaluation of Misstatements Identified during the Audit

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ISA 450 Evaluation of Misstatements Identified during the Audit

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ISA 450 *Evaluation of Misstatements Identified during the Audit*

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

Introduction, Objective, Definitions

International Standards on Auditing: ISA 450.01-04

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 (Revised) takes into account the auditor's evaluation of uncorrected misstatements, if any, on the financial statements, in accordance with this ISA.[1] ISA 320[2] deals with the auditor's responsibility to apply the concept of materiality appropriately in planning and performing an audit of financial statements.

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1 ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements, paragraphs 10-11*

2 ISA 320, *Materiality in Planning and Performing an Audit*

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 reported amount, classification, presentation, or disclosure of a 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, 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.

ISA Application and Other Explanatory Material: ISA 450.A1

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, including inadequate or incomplete disclosures, and those disclosures required to meet disclosure objectives of certain financial reporting frameworks as applicable;[6]

(c) An incorrect accounting estimate arising from overlooking, or clear misinterpretation of, facts;

(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.

(e) An inappropriate classification, aggregation or disaggregation, of information; and

(f) For financial statements prepared in accordance with a fair presentation framework, the omission of a disclosure necessary for the financial statements to achieve fair presentation beyond disclosures specifically required by the framework.[7]

Examples of misstatements arising from fraud are provided in ISA 240.[8]

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6 For example, International Financial Reporting Standard 7 (IFRS), *Financial Instruments: Disclosures* , paragraph 42H states that "an entity shall disclose any additional information that it considers necessary to meet the disclosure objectives in paragraph..."

7 For example, IFRS requires an entity to provide additional disclosures when compliance with the specific requirements in IFRS is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance (International Accounting Standard 1, *Presentation of Financial Statements* , paragraph 17(c)).

8 ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* , paragraphs A1-A6

How do we comply with the Standards?

[ISA | KAEGHDWC]

1 Accumulate, communicate and evaluate misstatements [ISA | 4433]

What do we do?

Accumulate, communicate and evaluate misstatements.

Why do we do this?

The existence of material misstatements in the financial statements is one of the reasons that can prevent us from issuing an unqualified opinion. If we fail to accumulate, communicate and evaluate misstatements, we may issue an inappropriate unqualified opinion.

Execute the Audit

What is a misstatement? [ISA | 4433.1300]

A misstatement, if material individually or in combination with other misstatements, causes the financial statements not to be presented fairly in conformity with the applicable financial reporting framework.

A misstatement may relate to a difference between the reported amount, classification, presentation or disclosure of a financial statement item and the amount, classification, presentation or disclosure that should be reported in conformity with the applicable financial reporting framework.

How do we determine whether a misstatement exists? [ISA | 4433.1400]

To determine whether a misstatement exists, we look at the applicable financial reporting framework - i.e. applicable accounting principles. Without the financial reporting framework, we would have no measure against which to assess whether a misstatement exists.

What is the applicable financial reporting framework? [ISA | 4433.14375]

The applicable financial reporting framework is the financial reporting framework adopted by management and, when appropriate, those charged with governance in the preparation of the financial statements, that is acceptable in light of the nature of the entity and the objective of the financial statements, or that is required by law or regulation.

What is a 'financial reporting framework'? [ISA | 4433.14376]

All financial statements are prepared in accordance with a financial reporting framework.

A 'financial reporting framework' is a set of criteria used to determine measurement, recognition, presentation and disclosure of all material items appearing in the financial statements.

> For example, US GAAP and IFRS are commonly used financial reporting frameworks.

Are there differences that are not misstatements? [ISA | 4433.14377]

Yes. There may be differences that we may encounter during the audit that we do not consider to be misstatements, for example:

- immaterial rounding differences - management booked $20,500 for an estimate that was calculated to be $20,450 or there is a slight difference in a financial statement disclosure due to how amounts are rounded;
- reconciling items that are appropriate based on the circumstances;
- unaddressed differences/reconciling items that management decides not to follow up on further after considering the risks, the materiality level(s), etc.

From what may misstatements result? [ISA | 4433.14378]

Misstatements may result from:

- an inaccuracy in gathering or processing data from which the financial statements are prepared;
- an omission of an amount or disclosure, including inadequate or incomplete disclosures;
- a financial statement disclosure that is not presented in accordance with the applicable financial reporting framework;
- an incorrect accounting estimate arising from overlooking, or clear misinterpretation of, facts;
- judgments of management concerning accounting estimates that we consider unreasonable;
- the selection and application of accounting policies that we consider inappropriate;
- an inappropriate classification, aggregation or disaggregation, of information;
- the omission of a disclosure necessary for the financial statements to achieve fair presentation beyond disclosures specifically required by the framework; and
- fraud. Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users. Fraudulent misstatements may arise from, for example:
  - the efforts of management to manage earnings;
  - misleading disclosures that have resulted from bias in management's judgments; or
  - extensive duplicative or uninformative disclosures that are intended to obscure a proper understanding of matters in the financial statements.

Who may identify misstatements? [ISA | 4433.1600]

Misstatements may be identified by:

- us, including specific team members (e.g. IT Audit or tax), KPMG specialists, and others under our direction;
- component auditors;
- internal auditors or others under the direction of management or those charged with governance;
- management or other employees;
- external parties engaged by management - e.g. management's specialists, consultants and other auditors; or
- other external parties - e.g. regulators, customers and whistle-blowers.

What are the types of misstatements that may be identified? [ISA | 4433.14021]

The nature of the misstatements may vary. They could be:

- misstatements due to:
  - error - i.e. unintentional misstatement; or
  - fraud - i.e. intentional misstatement;
- misstatements in:
  - accounts - i.e. monetary misstatements; or
  - disclosures - i.e. omission of disclosures or presentation of inaccurate or incomplete disclosures;
- misstatements that:
  - are factual; or
  - represent our best estimate of the total misstatement in an account, i.e. projected misstatements when using audit sampling and judgmental misstatements related to accounting estimates;
- classification misstatements that relate to:
  - accounts within the balance sheet only;
  - accounts within the income statement only; or
  - items within the same activity (operating, investing, financing) in the statement of cash flows; and
- misstatements that:
  - affect the income statement and/or balance sheet, as well as the statement of cash flows; or
  - result from preparing the statement of cash flows itself, and so only affect the statement of cash flows.

What is a factual misstatement, a projected misstatement and a judgmental misstatement? [ISA | 4433.14385]

Type of misstatement	What is it?
Factual misstatement	A factual misstatement is a misstatement about which there is no doubt.

Judgmental misstatement	A judgmental misstatement is our best estimate of the misstatement in an account or disclosure in which judgment is involved. It is a difference arising from the judgments of management concerning accounting estimates or the selection or application of accounting principles.
Projected misstatement	A projected misstatement is our best estimate of the misstatement in populations involving audit sampling. It is the projection of misstatements identified in a sample to the entire population from which the sample items were drawn.

How could misstatements affect the statement of cash flows? [ISA | 4433.14386]

Although many of the misstatements we identify affect the balance sheet and/or the income statement, misstatements can also affect the statement of cash flows in two ways. For example, we may identify misstatements that:

- affect the income statement and/or balance sheet, as well as the statement of cash flows - e.g. misstatements that affect net income may also affect cash flows from operations; or
- result from preparing the statement of cash flows itself, which may only affect the statement of cash flows, not the income statement and/or balance sheet- e.g. a misclassification between two captions of the statement of cash flows.

Example: Misstatement affecting the statement of cash flows that is the result of preparing the statement

Fact pattern

As part of the process of preparing the statement of cash flows, Entity A analyzes the transactions recorded within the property, plant and equipment account and identifies this activity within the account:

Beginning balance(12/31/X1)	Depreciation	Sale of assets	Ending balance(12/31/X2)
$254,000	($50,000)	($15,000)	$189,000

Based on their analysis, management includes $50,000 of depreciation as an add back to net income (within adjustments to net income in the cash flows from operating activities) and $15,000 as a cash inflow from the sale of assets (within cash flows from investing activities).

When performing our audit procedures over the statement of cash flows, we identify that the assets were sold for $45,000 cash, resulting in a gain on the sale of $30,000:

Cash received	Value of assets sold	Gain on sale
$45,000	($15,000)	$30,000

Analysis

The gain is recorded correctly in the income statement, but management erroneously combined the gain and the proceeds of the sale into one line in the statement of cash flows, resulting in a misstatement. Under the financial reporting framework - e.g. IFRS and US GAAP -, proceeds from the sale of assets and the gain/loss from the sale are included separately in the investing activities and the operating activities, respectively.

Item	Amount determined by the entity	Correct amount	Difference/ Misstatement
Operating activities (adjustments to net income)			
Depreciation	50,000	50,000	--
Gain on sale of assets	--	(30,000)	(30,000)
Investing activities			
Proceeds from sale of assets	15,000	45,000	30,000

Although no misstatement exists within an account in the balance sheet or income statement, a misstatement exists within amounts in the statement of cash flows:

Investing activities 30,000

Operating activities (30,000)

When do we accumulate, communicate and evaluate the misstatements identified? [ISA | 4433.14005]

When a misstatement is identified, we start accumulating, communicating and evaluating it on a timely basis. In view of the potential effect on our audit approach and our conclusions, we consider misstatements throughout our audit, not just at the end of the audit.

Think about how a car racing team might approach a motor race. During the race, the driver or the pit crew may identify issues with the car and adjust their racing strategy accordingly. These adjustments include reacting to external factors, such as how other racers are driving, and internal factors, such as the wear on the car's tires and fuel levels. If they wait until the end of the race to adjust for issues identified, it may be too late to react and they could lose the race.

Similarly, in our audits, we do not wait until the end of the audit to accumulate, communicate, evaluate and react to misstatements that arise in our audit.

What are the benefits of accumulating and evaluating misstatements throughout the audit? [ISA | 4433.1801]

The benefits of accumulating and evaluating misstatements throughout the audit, as opposed to only at the end of the audit, are:

- we are less likely to forget about misstatements identified;
- we are able to evaluate the matters while they are fresh in our mind; and
- we have sufficient time to modify our audit procedures to address any revisions in our risk assessments or an increased risk of possible undetected misstatements.

What activities do we perform to accumulate, communicate and evaluate misstatements? [ISA | 4433.1800]

When we identify misstatements, we:

- accumulate identified misstatements;
- consider the possibility of undetected misstatements and its implications;
- evaluate management's examination of an account or disclosure in response to misstatements detected by us;
- communicate accumulated misstatements to management and request their correction;
- evaluate management bias in the selective correction of misstatements;
- evaluate management bias in the identification of offsetting adjustments;
- evaluate whether uncorrected misstatements are material and the implications;
- communicate misstatements with those charged with governance;
- obtain written representations for all financial statement periods;
- evaluate the nature, circumstances, effect and implications of misstatements.

Accumulation of Identified Misstatements

International Standards on Auditing: ISA 450.05

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 - A6)

ISA Application and Other Explanatory Material: ISA 450.A2-A6

Accumulation of Identified Misstatements (Ref: Para. 5)

"Clearly Trivial"

A2. Paragraph 5 of this ISA requires the auditor to accumulate misstatements identified during the audit other than those that are clearly trivial. "Clearly trivial" is not another expression for "not material." Misstatements that are clearly trivial will be of a wholly different (smaller) order of magnitude, or of a wholly different nature than those that would be determined to be material, and will be misstatements 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 misstatement is considered not to be clearly trivial.

Misstatements in Individual Statements

A3. The auditor may designate an amount below which misstatements of amounts in the individual statements 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. However, misstatements of amounts that are above the designated amount are accumulated as required by paragraph 5 of this ISA. In addition, misstatements relating to amounts may not be clearly trivial when judged on criteria of nature or circumstances, and, if not, are accumulated as required by paragraph 5 of this ISA.

Misstatements in Disclosures

A4. Misstatements in disclosures may also be clearly trivial whether taken individually or in aggregate, and whether judged by any criteria of size, nature or circumstances. Misstatements in disclosures that are not clearly trivial are also accumulated to assist the auditor in evaluating the effect of such misstatements on the relevant disclosures and the financial statements as a whole. Paragraph A17 of this ISA provides examples of where misstatements in qualitative disclosures may be material.

Accumulation of Misstatements

A5. Misstatements by nature or circumstances, accumulated as described in paragraphs A3 - A4, cannot be added together as is possible in the case of misstatements of amounts. Nevertheless, the auditor is required by paragraph 11 of this ISA to evaluate those misstatements individually and in aggregate (i.e., collectively with other misstatements) to determine whether they are material.

A6. 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 including those concerning recognition, measurement, presentation and disclosure in the financial statements (including the selection or application of accounting policies) that the auditor considers unreasonable or 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.[9]

9 ISA 530, *Audit Sampling* , paragraphs 14-15

How do we comply with the Standards? [ISA | KAEGHDWC]

1 Accumulate identified misstatements [ISA | 4434]

What do we do?

Accumulate identified misstatements.

Why do we do this?

We may identify a number of misstatements while we are performing our audit procedures throughout the audit. Accumulating these identified misstatements helps to determine whether one or a combination of misstatements are material to the financial statements or affect our planned audit approach.

Imagine we have a leaky faucet at our house. While initially a few drops of water leaking out of the faucet may appear minor, that view may change when we see the overall effect on our water bill.

Similarly, the misstatements we identify during the audit may also appear immaterial at first, but when they are accumulated, we may find that they have a more significant effect on the financial statements and/or our overall audit.

Execute the Audit

What activities do we perform to accumulate identified misstatements? [ISA | 4434.1300]

To accumulate the identified misstatements, we first determine the amount of the misstatements. Then, we determine whether the misstatements are clearly trivial. The Audit Misstatement Posting Threshold (AMPT) and, if the entity is a group, the Audit Misstatement Reporting Threshold (AMRT) are two measures that help us to determine whether the misstatements are clearly trivial. If the misstatements are not clearly trivial, we accumulate them in the Summary of Audit Misstatements (SAM).

In summary, we perform the following activities:

- accumulate misstatements that are not clearly trivial in the SAM ;
- determine AMPT, lower AMPT and their revisions, if applicable ;
- determine AMRT, lower AMRT and their revisions, if applicable ; and
- determine the amount of the judgmental and projected misstatements .

1.1 Accumulate misstatements that are not clearly trivial in the SAM [ISA | 4435]

What do we do?

Accumulate misstatements identified during the audit that are not clearly trivial in the Summary of Audit Misstatements - corrected and uncorrected sections - distinguishing between factual, judgmental and projected misstatements.

Why do we do this?

Although we may identify a number of misstatements during the audit, we may not necessarily accumulate all of them. We do not accumulate clearly trivial misstatements identified in both accounts and disclosures because their accumulation would not have a material effect on the financial statements, individually or in combination with other misstatements.

Execute the Audit

Which misstatements do we accumulate? [ISA | 4435.1300]

We accumulate all misstatements that are not clearly trivial, identified in both accounts and disclosures and that arose in both the current period and prior periods.

Misstatements in disclosures may also be clearly trivial. Even though we cannot 'add up' the misstatements in disclosures numerically, we still accumulate the ones that are not clearly trivial and evaluate their effect collectively with other misstatements identified.

Where do we accumulate the misstatements that are not clearly trivial? [ISA | 4435.1400]

We accumulate the misstatements that are not clearly trivial in the Summary of Audit Misstatements (SAM).

The SAM is a tool that we use to accumulate the misstatements that are not clearly trivial. It has two sections:

- *Uncorrected misstatements* section - to capture those misstatements identified by any party (us - including component auditors -, management or others) that management *did not correct* in the financial statements; and
- *Corrected misstatements* section - to capture those misstatements identified by us - including component auditors - that management *corrected* in the financial statements.

Do we distinguish between factual misstatements, judgmental misstatements and projected misstatements in the SAM? [ISA | 4435.1500]

Yes. To assist us in evaluating the effect of misstatements accumulated during the audit and in communicating misstatements to management and/or those charged with governance, we distinguish between factual misstatements, judgmental misstatements and projected misstatements in the SAM.

What is a factual misstatement, a projected misstatement and a judgmental misstatement? [ISA | 4435.14385]

Type of misstatement	What is it?
Factual misstatement	A factual misstatement is a misstatement about which there is no doubt.
Judgmental misstatement	A judgmental misstatement is our best estimate of the misstatement in an account or disclosure in which judgment is involved. It is a difference arising from the judgments of management concerning accounting estimates or the selection or application of accounting principles.
Projected misstatement	A projected misstatement is our best estimate of the misstatement in populations involving audit sampling. It is the projection of misstatements identified in a sample to the entire population from which the sample items were drawn.

Which are the clearly trivial misstatements that we do not accumulate? [ISA | 4435.1600]

Clearly trivial misstatements are those that are inconsequential, whether taken individually or in the aggregate, and whether judged by any criteria of size, nature or circumstances.

We do not accumulate clearly trivial misstatements identified in both accounts and disclosures because their accumulation would not have a material effect on the financial statements.

Is 'clearly trivial' the same as 'not material'? [ISA | 4435.14420]

No. 'Clearly trivial' is not the same as 'not material'. Clearly trivial misstatements are of a smaller magnitude, or a wholly different nature, than those that are material. We likely consider only a subset of those misstatements that are less than the materiality level(s) clearly trivial, as demonstrated in the diagram below.

Furthermore, the size of a misstatement is not our only consideration to determine whether it is clearly trivial. Its qualitative factors - i.e. the nature and circumstances of the misstatement - may also influence our views on whether a misstatement is "clearly trivial".

How do we determine whether a misstatement is clearly trivial? [ISA | 4435.1700]

We determine whether a misstatement is clearly trivial by taking into account:

- an amount known as the Audit Misstatement Posting Threshold (AMPT). We use the AMPT as a quantitative threshold for determining whether a misstatement is clearly trivial. See activity 'Determine AMPT, lower AMPT and their revisions, if applicable' for further information about how to set AMPT.
- relevant qualitative factors - i.e. nature and circumstances of a misstatement. Performing activity 'Evaluate the nature of and reasons for the misstatements' when the misstatement is identified helps us to determine whether there are qualitative factors that may indicate that the misstatement is not clearly trivial.

> Examples of qualitative matters include:
>
> - a misstatement involving fraud and/or illegal acts;
> - the potential effect of a misstatement on:
>   - the compliance with loan covenants;
>   - management's compensation - i.e. bonuses;
>   - whether earnings per share targets/expectations are met;
> - a misstatement that changes a loss into income or vice versa.
>
> The presence of one or more of these qualitative matters may be an indicator that the misstatement is not clearly trivial.

If a misstatement is above AMPT, it is not clearly trivial and we include it in the SAM.

If a misstatement is below AMPT, we consider it to be clearly trivial, unless there are qualitative factors - i.e. nature and circumstances of a misstatement - that suggest otherwise.

What do we do when there is uncertainty about whether one or more misstatements are clearly trivial? [ISA | 4435.14422]

When there is any uncertainty about whether one or more misstatements are clearly trivial, the matter is not trivial.

Group Audit or Component Audit | Is our approach to determining whether a misstatement is clearly trivial the same in a group audit and in a stand-alone audit? [ISA | 4435.14423]

No, the approach is different because in a group audit, the component auditors may report misstatements that are less than group AMPT to the group auditor, and, depending on the circumstances, the group auditor could consider those misstatements not clearly trivial when aggregated with other similar misstatements.

Group Audit or Component Audit | How do the component auditors determine what misstatements to report to the group auditor? [ISA | 4435.14424]

We, as the component auditors, determine what misstatements to report to the group auditor by taking into account:

- an amount known as the Audit Misstatement Reporting Threshold (AMRT). We use the AMRT as a quantitative threshold for determining what misstatements to report to the group auditor. See activity 'Determine AMRT, lower AMRT and their revisions, if applicable' for further information about how to set AMRT and why.

- relevant qualitative factors - i.e. nature and circumstances of a misstatement. Performing activity 'Evaluate the nature of and reasons for the misstatements' when the misstatement is identified helps us to determine whether there are qualitative factors that may indicate that the misstatement is not clearly trivial for the group.

If a misstatement is above AMRT, we report it to the group auditor.

If a misstatement is below AMRT, we do not report it to the group auditor, unless there are qualitative factors - i.e. nature and circumstances of a misstatement - that merit reporting.

We report uncorrected and corrected misstatements separately.

Group Audit or Component Audit | How does the group auditor determine whether a misstatement is clearly trivial? [ISA | 4435.14425]

We, as the group auditor, consider all misstatements that we are aware of (e.g. identified by us, identified by management, communicated by component auditors) and determine whether they are clearly trivial. We determine whether a misstatement is clearly trivial by taking into account:

- an amount known as the group AMPT. The group auditor uses the group AMPT as a quantitative threshold for determining whether a misstatement (or group of misstatements by account or disclosure across the group) is clearly trivial. See activity 'Determine AMPT, lower AMPT and their revisions, if applicable' for further information about how to set group AMPT.
- relevant qualitative factors - i.e. nature and circumstances of a misstatement. Performing activity 'Evaluate the nature of and reasons for the misstatements' when the misstatement is identified helps us to determine whether there are qualitative factors that may indicate that the misstatement is not clearly trivial.

Examples of qualitative matters include:

- a misstatement involving fraud and/or illegal acts;
- the potential effect of a misstatement on:
    - the compliance with loan covenants;
    - management's compensation - i.e. bonuses;
    - whether earnings per share targets/expectations are met;
- a misstatement that changes a loss into income or vice versa.

The presence of one or more of these qualitative matters may be an indicator that the misstatement is not clearly trivial.

In this determination, we may follow the following steps:

Steps	What may we do?
Consideration of	We may aggregate misstatements that are of the same type. Misstatements are of the same type when:

misstatements in aggregate	• the misstatements affect the same accounts • the nature of and reasons for the misstatements are the same. We use judgment if we consider offsetting overstatements and understatements. It may not be appropriate to offset misstatements within the same account balances when: • some or all misstatements are above group AMPT; • those misstatements affect presentation and/or disclosures in the financial statements; • there are both estimated misstatements (projected or judgmental) and more precise (factual) misstatements; and • offsetting is not consistent with the applicable financial reporting framework. If the aggregated amount(s) is above group AMPT, it is not clearly trivial and we include it in the group SAM. If the aggregated amount(s) is below group AMPT, we consider it to be clearly trivial, unless there are qualitative factors - i.e. nature and circumstances of the misstatements - that suggest otherwise. For example, if group AMPT is $100 and there are two uncorrected misstatements in the accounts receivable/revenue accounts that represent overstatements - one for $50 in component A and the other one for $80 in component B - both misstatements are not clearly trivial as the aggregate is $130, which is above group AMPT. We include in the group SAM a misstatement of $130.
Consideration of misstatements individually	We may compare the other misstatements that were not aggregated with group AMPT individually. If a misstatement is above group AMPT, it is not clearly trivial and we include it in the group SAM. If the misstatement is below group AMPT, we consider it to be clearly trivial, unless there are qualitative factors - i.e. nature and circumstances of the misstatements - that suggest otherwise.
Consideration of patterns in misstatements	We analyze whether there are any patterns in the misstatements that could indicate an issue across the group. For example, • misstatements in the same accounting estimate across many components that have the same effect in the financial statements - consistent overstatement or consistent understatement - may indicate that there may be management bias and that those misstatements are not clearly trivial.

- misstatements in the same account across many components - even if the other side of the entries affect multiple accounts - may indicate that those misstatement are not clearly trivial, depending on the circumstances.

Finally, we consider corrected and uncorrected misstatements separately as these misstatements are included in different sections in the group SAM.

For example, if group AMPT is $100 and there are two misstatements in the accounts receivable/ revenue accounts that represent overstatements in component A - one corrected for $50 and the other one uncorrected for $80 - we do not include them in the group SAM as we do not aggregate corrected misstatements with uncorrected misstatements. We separately assess if the uncorrected misstatement aggregates with other uncorrected misstatements and if it is quantitatively not clearly trivial.

Examples

How does an engagement team determine whether a misstatement is clearly trivial? [ISA | 4435.1800]

Scenario 1 **: Clearly trivial misstatement**

Fact pattern

An engagement team is performing an audit of the financial statements of Entity A, which acquired 10 new fixed assets during the period amounting to $1,000,000 in total. AMPT is $5,000.

One of the planned substantive audit procedures over property, plant, and equipment is to inspect supporting third party invoices for each of the 10 fixed asset additions. In performing the audit procedures, the engagement team discovers a difference of $3,500 between the recorded amount of an asset and the amount given on the supporting invoice. They determine that this is the result of a simple human mistake and is not intentional.

Analysis

As a result, the engagement team concludes that the $3,500 misstatement is clearly trivial because it is below AMPT and there is nothing about the nature of or the reason for the misstatement that suggests it is more than inconsequential.

Scenario 2 **: Misstatement that is not clearly trivial**

Fact pattern

Let us assume the same facts as in Scenario 1. However, this time, the engagement team determines that the difference of $3,500 is the result of the CFO misappropriating assets of the entity.

Analysis

While the misstatement identified is below the AMPT of $5,000, the misstatement is not clearly trivial because it involves fraud by a member of senior management.

As a result, the engagement team accumulates the $3,500 misstatement in the SAM and evaluates the effect on the audit - e.g. considering other implications on the audit like management's integrity and client continuance evaluation.

1.2 Determine AMPT, lower AMPT and their revisions, if applicable [ISA | 688]

What do we do?

Determine the Audit Misstatement Posting Threshold (AMPT) and the lower AMPT for particular accounts and disclosures AND revise if applicable.

Why do we do this?

The Audit Misstatement Posting Threshold (AMPT) is an amount that helps us determine, in practice, whether a misstatement is 'clearly trivial.'

If misstatements are 'clearly trivial,' we do not accumulate them, because their accumulation would not have a material effect on the financial statements, individually or in combination with other misstatements.

Execute the Audit

What is AMPT? [ISA | 688.11753]

AMPT is a quantitative threshold for determining whether a misstatement is clearly trivial (see question 'How do we determine whether a misstatement is clearly trivial?').

How do we determine AMPT? [ISA | 688.1300]

We determine AMPT at an amount that does not exceed five percent of materiality.

When determining whether to set AMPT below five percent, we think about factors that indicate increased aggregation risk (see question 'What factors do we consider that affect aggregation risk?').

The resulting AMPT is an amount below which a misstatement would not be quantitatively material:

- individually;
- when combined with other misstatements; and
- when considering the possibility of undetected misstatements.

When and how do we determine a lower AMPT for a particular account or disclosure? [ISA | 688.1400]

When we establish a lower materiality level for particular accounts or disclosures, we determine a lower AMPT amount for each of those particular accounts or disclosures at an amount that does not exceed five percent of that lower materiality amount.

When determining a lower AMPT for a particular account or disclosure, we think about factors similar to those when determining performance materiality for particular accounts or disclosures (see question 'What factors do we consider in determining performance materiality for a particular account or disclosure?').

In what circumstances do we revise AMPT during the audit? [ISA | 688.1500]

We revise AMPT - and, if applicable, AMPT for particular accounts and disclosures - when we lower our established materiality level(s).

We also consider whether to reduce AMPT if we increase our assessment of aggregation risk.

1.3 Group Audit or Component Audit | Determine AMRT, lower AMRT and their revisions, if applicable [ISA | 4436]

What do we do?

Determine the Audit Misstatement Reporting Threshold (AMRT) and the lower AMRT for particular accounts and disclosures. Revise those thresholds if applicable.

Why do we do this?

In an audit of the financial statements of a group, we may discover misstatements below group AMPT in more than one component. However, when aggregated, they may amount to a misstatement in an account or disclosure that is material. There is a greater possibility of this happening when the audit involves component auditors, because the group auditor may not have visibility into these smaller misstatements at every component.

As the group auditor, we determine the Audit Misstatement Reporting Threshold (AMRT) and a lower AMRT for particular accounts and disclosures to identify misstatements for which it may be appropriate to accumulate at the group level.

Execute the Audit

How do we set AMRT? [ISA | 4436.1300]

As the group auditor, we set AMRT at an amount up to 75% of group AMPT.

It is appropriate to set up an AMRT amount smaller than group AMPT to minimize the likelihood of not accumulating misstatements in the same account or disclosure that, in the aggregate, may exceed group materiality.

Consider these facts in an audit of the financial statements of an entity:

- the entity has only one significant account with a consolidated balance of $100,000;
- the established materiality is $5,000 and AMPT is $250 (5% of materiality);
- the entity has 25 components;
- the balance of the significant account is distributed evenly across the 25 components ($4,000 in each component); and
- we perform the audit procedures for one component and involve other independent auditors for the other 24 components.

During our audit procedures, we and the other auditors find a $240 misstatement within the one significant account in each component. As those misstatements are individually below AMPT, we may not accumulate them in the SAM initially.

However, when we add them all together, the total misstatement in the account is $6,000 ($240 x 25 components), which is above materiality for the financial statements as a whole.

When and how do we set a lower AMRT for a particular account or disclosure? [ISA | 4436.1500]

As the group auditor, when we establish a lower group AMPT for certain accounts or disclosures, we set a lower AMRT amount for each of those particular accounts or disclosures at an amount up to 75% of lower group AMPT.

When do we revise AMRT during the audit? [ISA | 4436.1600]

As the group auditor, if, during the audit, we reduce group AMPT or reduce lower group AMPT, we revise AMRT, or lower AMRT.

1.4 Determine the amount of the judgmental and projected misstatements [ISA | 4437]

What do we do?

IF the misstatement identified relates to an accounting estimate or substantive procedures that involve audit sampling, THEN determine the judgmental or projected misstatement, respectively - i.e. the 'best estimate' of the total misstatement.

Why do we do this?

Before accumulating the misstatements, we determine their amount if the misstatements are not factual. The amount of some misstatements may not be easy to determine.

Execute the Audit

In what situations is the amount of a misstatement not easily determinable? [ISA | 4437.1300]

When:

- the misstatement relates to sample items - i.e. we are using audit sampling (e.g. Monetary Unit Sampling (MUS) or the KPMG Sampling Plan (KSP) or
- there is a range of acceptable values - e.g. in some accounting estimates,

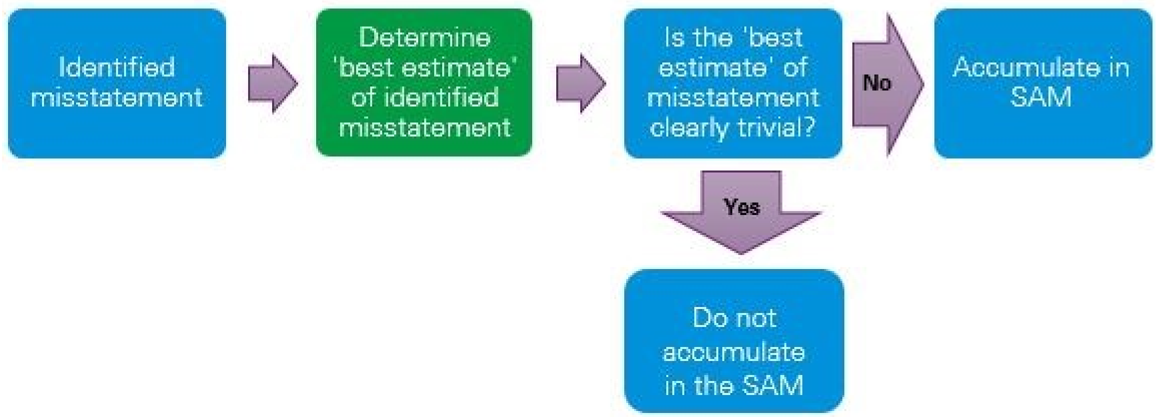
determining the total amount of a misstatement may not be as easy.

In contrast, in many instances, the amount of a misstatement is clear and easy to determine. This is the case when we identify a factual misstatement.

> For example, during a substantive audit procedure, we may identify a difference between what the entity recorded and a single amount that is supported by our audit evidence (e.g. an underlying invoice).

What do we do if the amount of a misstatement is not easily determinable? [ISA | 4437.1400]

If the amount of a misstatement is not easily determinable, we determine the 'best estimate' of the total misstatement - i.e. projected or judgmental misstatements. We include those projected and judgmental misstatements in the SAM if they are not clearly trivial.



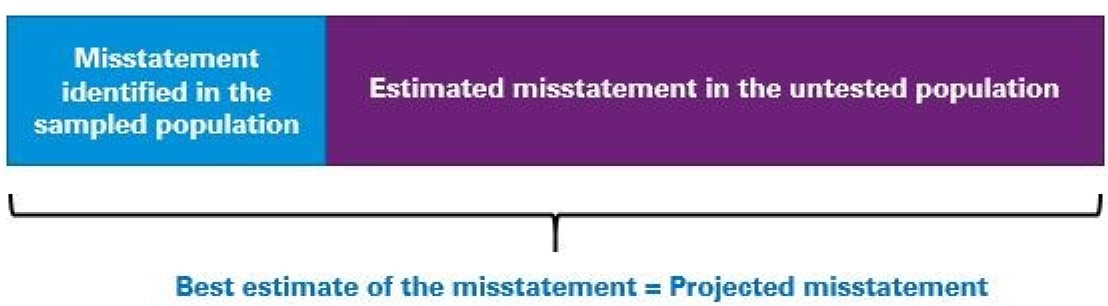
What is the best estimate of a misstatement that we identify when we use audit sampling? [ISA | 4437.1500]

The best estimate of a misstatement that we identify when we use audit sampling is the 'projected misstatement'. See activity 'Calculate the total factual and projected misstatement when using MUS or KSP ' for further information.

What comprises the projected misstatement?

The total misstatement we find in an account when we perform audit procedures using audit sampling includes more than the errors we identify.

The projected misstatement comprises the actual misstatement we identified in the sampled population plus the amount of the estimated misstatement in the untested population.



When we perform audit procedures using audit sampling, we only know the misstatement in the tested items but not the misstatement in the untested items. Consequently, we 'project' the misstatement that we identified in the tested items to the entire population (this process is also known as 'extrapolation').

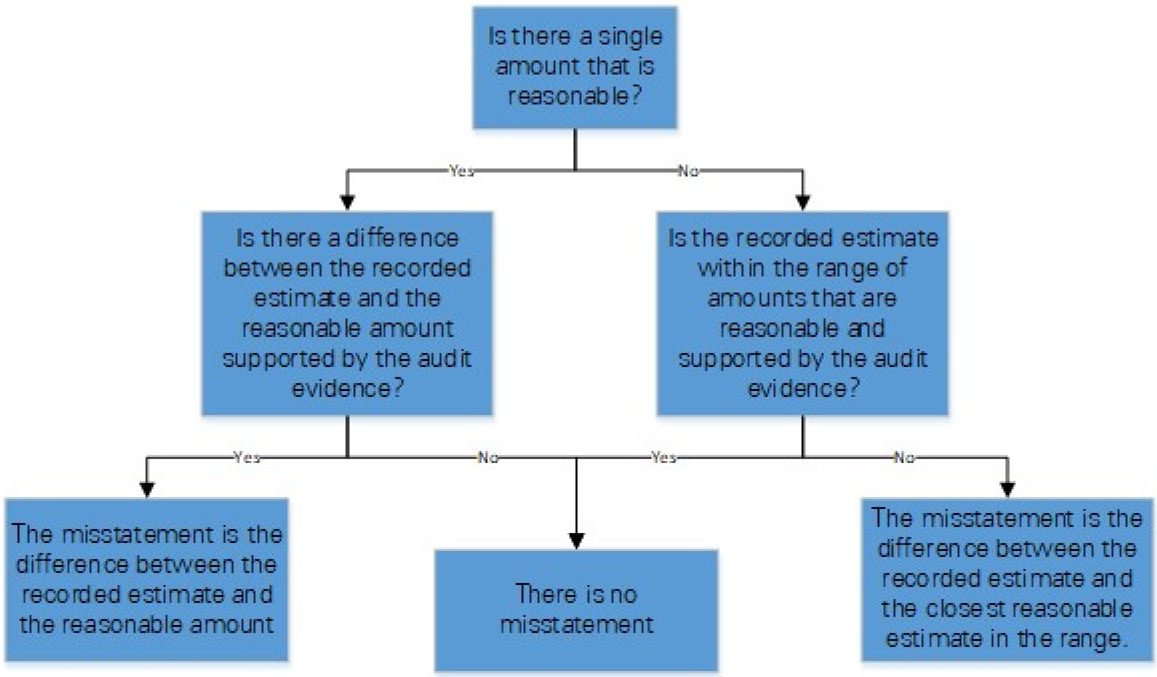
Moreover, if there are individually significant items in the account and we tested them separately, they are not part of the sampled population. Therefore, we also add the misstatements we identify in those items to the projected misstatement to determine the best estimate of the total misstatement in the account.

What is the best estimate of a misstatement in an accounting estimate? [ISA | 4437.1700]

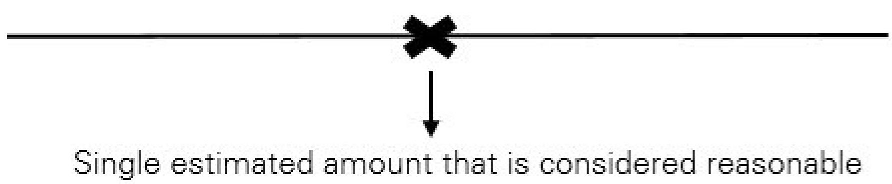
The best estimate of a misstatement in an accounting estimate is the judgmental misstatement.

How do we determine the judgmental misstatement?

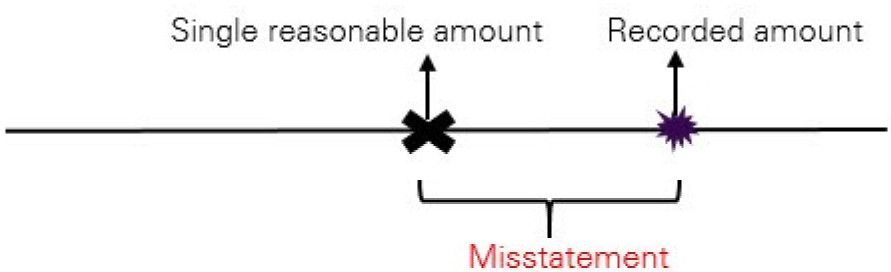
This flowchart provides a quick reference guide for determining the best estimate of a misstatement in an accounting estimate - i.e. the judgmental misstatement.



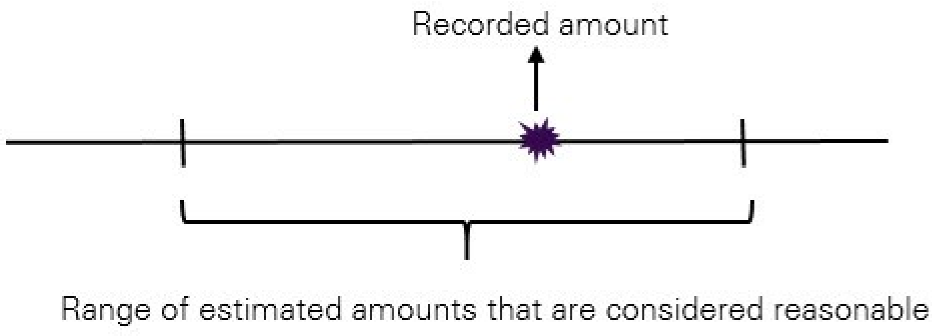
Single estimated amount that is considered reasonable or correct:



When the accounting estimate is determined as a single amount that is considered reasonable, the amount of a misstatement is likely easy to determine. In these instances, the misstatement is simply the difference between the recorded estimate and the reasonable amount.

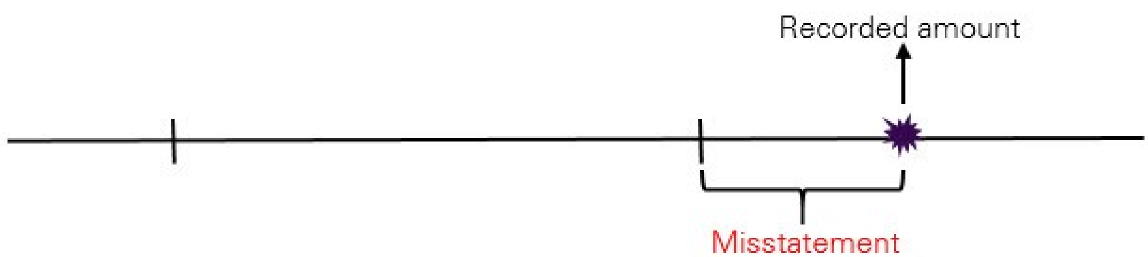


Range of estimated amounts that are considered reasonable:



When there is a range of estimated amounts, our consideration of possible misstatements is slightly different. As long as the estimate recorded by management is within the range, there is no misstatement.

However, if the estimate recorded by management is outside of the range of reasonable estimates, the difference between the recorded estimate and the closest reasonable estimate in the range is a misstatement.



What is the best estimate of a misstatement in an accounting estimate if we use audit sampling to test the estimate? [ISA | 4437.14429]

If we use audit sampling to test an accounting estimate (e.g. testing the fair value of a sample of individual investments when there are observable prices in an active market), the best estimate of the misstatement is a projected misstatement, not a judgmental misstatement.

Examples

How does an engagement team determine the best estimate of the misstatement in an accounting estimate? [ISA | 4437.1800]

Fact pattern

Entity A records an estimate for their allowance for bad debts of $50 million as of the end of the period. As part of the engagement team's audit procedures, they inspect evidence of subsequent receipts of outstanding account balances to develop an independent estimate of the allowance for bad debts. Because the entity's payment terms are net 10 days and the entity's customers ordinarily pay within 10 days, the exact amount of bad debt can be determined, based on audit evidence, as $52 million. Note that 10 days after period end have already passed.

Analysis

In this case, the amount of the estimate recorded by the entity is different from the amount that is best supported by audit evidence. This difference represents a misstatement of $2 million ($50 million versus $52 million).

Consideration of Identified Misstatements as the Audit Progresses

International Standards on Auditing: ISA 450.06-07

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. A7)

(b) The aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with ISA 320. (Ref: Para. A8)

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. A9)

ISA Application and Other Explanatory Material: ISA 450.A7-A9

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

A7. 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.

A8. 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.[10]

10 ISA 530, paragraph 5(c)-(d)

A9. 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 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.

How do we comply with the Standards? [ISA | KAEGHDWC]

1 Evaluate the nature, circumstances, effect and implications of misstatements [ISA | 4454]

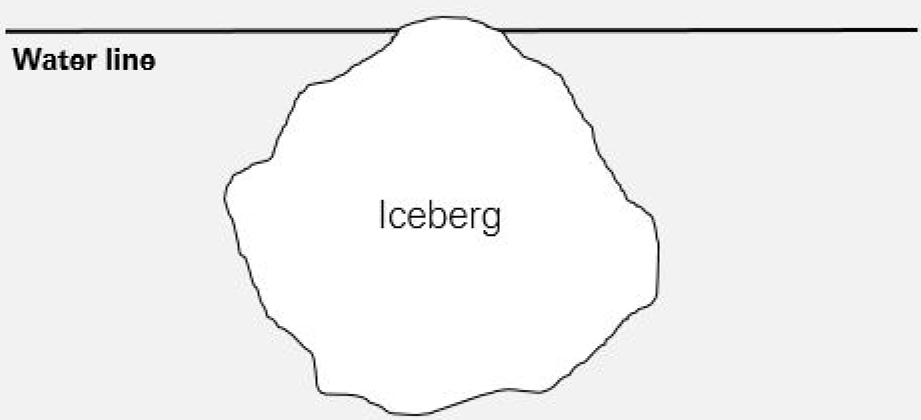
What do we do?

Evaluate the nature, circumstances, effect and implications of misstatements identified.

Why do we do this?

We cannot assume that a misstatement is merely an isolated occurrence. Sometimes, a misstatement can be an indication that there is a bigger issue.

This is similar to how we might think about an iceberg that is sitting in the middle of the ocean. Although many times we can only see its tip, there can be much more to it lurking under the water.



Due to the potential implications of misstatements on our risk assessments and our audit approach, we carefully consider the nature, circumstances, effects and implications of the misstatements we identify.

Execute the Audit

How do we evaluate the nature, circumstances, effect and implications of misstatements identified? [ISA | 4454.1300]

We evaluate the nature, circumstances, effect and implications of misstatements identified by performing the following activities:

- evaluate the nature of and reasons for the misstatements ;
- evaluate the effect of misstatements on the assessed risks of material misstatement ;
- evaluate whether misstatements are the result of fraud and the implications .

1.1 Evaluate the nature of and reasons for the misstatements [ISA | 4455]

What do we do?

Evaluate the nature of and the reasons for the identified misstatements individually and in aggregate. In particular, determine whether misstatements indicate the existence of control deficiencies AND if not, document our rationale.

Why do we do this?

Understanding the nature of a misstatement and why it occurred can be helpful as we consider whether the misstatement indicates:

- an additional risk of material misstatement;
- a change in our assessment of an existing risk of material misstatement;
- fraud;
- a control deficiency; or
- other possible undetected misstatements.

Execute the Audit

Over what misstatements do we perform our evaluation? [ISA | 4455.1300]

We perform our evaluation over:

- all individual misstatements identified regardless of whether they are:
  - accumulated in the SAM or not (i.e. we perform the evaluation over individual misstatements that are clearly trivial as well, not only the accumulated misstatements);
  - related to a prior period or the current period; or
  - misstatements in accounts or disclosures.
- all accumulated misstatements in aggregate (i.e. in the evaluation in aggregate, we do not consider clearly trivial misstatements, only the accumulated misstatements). When there are many misstatements or a few large ones, they may be the result of more pervasive control deficiencies - e.g. deficiencies in the CERAMIC.

Are there differences that are not misstatements and over which we do not perform this evaluation? [ISA | 4455.1400]

Yes. There may be differences that we may encounter during the audit that we do not consider to be misstatements and over which we do not perform this evaluation, for example:

- immaterial rounding differences - management booked $20,500 for an estimate that was calculated to be $20,450 or there is a slight difference in a financial statement disclosure due to how amounts are rounded;
- reconciling items that are appropriate based on the circumstances;
- unaddressed differences/reconciling items that management decides not to follow up on further after considering the risks, the materiality level(s), etc.

When do we perform our evaluation of the identified misstatements? [ISA | 4455.1500]

We perform our evaluation as the misstatements are identified; we do not wait until the end of the audit.

How do we evaluate the misstatements identified? [ISA | 4455.1600]

When we identify a misstatement, we evaluate:

- its nature and
- the circumstances in which it occurred. This means that we evaluate why the misstatement occurred. In particular, we evaluate whether the misstatement is the result of one or more control deficiencies.

In general, misstatements that we detect, and the entity does not, are evidence that there is a deficiency in internal control.

What do we do when we do not think that a misstatement is the result of a control deficiency? [ISA | 4455.14490]

If we do not identify one or more control deficiencies related to a misstatement, we document our rationale.

Examples of situations in which a misstatement is not the result of a control deficiency are:

- When management identifies a misstatement but decides not to book it because it is not material or
- When we identify a misstatement that is the result of a non-GAAP policy of the entity.

What factors do we think about in our evaluation of the misstatements identified? [ISA | 4455.14492]

The table shows some factors we may think about when we evaluate the nature of an individual misstatement and the reason for its occurrence:

	Examples of factors we think about	
Nature of a misstatement	Misstatements could: • arise from error or fraud; • be misstatements in amounts or misstatements in disclosures;	**Reason for a misstatement**

	• be classification misstatements; • affect the balance sheet, the income statement and/or the statement of cash flows; • affect a non-significant account.	
Misstatements could arise from: • matters specific to an area in the financial statements, such as: - management's misunderstanding of accounting requirements; - control deficiencies specific to an area; - fraud; or - an isolated human error. • pervasive matters, such as: - management's inappropriate assumptions or valuation methods that have been widely applied by the entity; - control deficiency related to the competence of accounting and finance personnel;		

- a widespread breakdown in internal control, e.g. issue with the control environment component; or - management bias.		

1.2 Evaluate the effect of misstatements on the assessed risks of material misstatement [ISA | 4456]

What do we do?

Evaluate the effect of the individual misstatements accumulated during the audit on the assessed risks of material misstatement.

Why do we do this?

Once we have determined that we have a sufficient understanding of the nature of an individual misstatement and the reason for which it occurred, we are in a better position to evaluate the effects the misstatements have on the assessed risks of material misstatement. The misstatements may represent evidence that contradicts the information on which we originally based our risk assessments.

Execute the Audit

Over what misstatements do we perform our evaluation of the effect of the misstatements on the assessed risks of material misstatement? [ISA | 4456.1300]

We perform our evaluation of the effect of the misstatements on the assessed risks of material misstatement over the accumulated misstatements -corrected and uncorrected. We do not perform this evaluation over the clearly trivial misstatements.

What are the effects a misstatement may have on our risk assessment? [ISA | 4456.1400]

A misstatement may affect our risk assessments by:

- introducing a new risk of material misstatement.
- increasing the level of the risk of material misstatement - i.e. a risk previously identified may be higher than we originally thought during planning; or
- modifying our control risk assessment. If the misstatement is the result of a control deficiency, the deficiency may affect our control risk assessment.

Note that if we identify a misstatement in a non-significant account and a new risk of material misstatement is identified and associated to that account, we determine that the account is a significant account.

How do we respond when a misstatement affects our risk assessment? [ISA | 4456.1500]

When a misstatement affects our risk assessment, we modify the nature, timing and extent of our audit procedures, or design and perform additional procedures to address the revised risks.

Example

How does an engagement team determine the effect of a misstatement on the risks of material misstatements? [ISA | 4456.1600]

Fact pattern

The engagement team performs a search for unrecorded liabilities in the audit of entity DPH's financial statements by selecting a sample of disbursements made by the entity after period-end and:

- inspecting the invoice(s) and payment information associated with the sampled items and determining the period the disbursement relates to; and
- comparing the amount with the general ledger and/or sub ledger information - e.g. detail of accounts payable or accrued liabilities - to determine whether the amounts are recorded in the proper period.

As part of performing the procedures, the engagement team identifies an invoice the entity received for monthly lease payments; however, they are not aware that the entity has entered into any significant lease agreement. Consequently, they did not identify risks of material misstatement related to leasing transactions and they did not identify lease related accounts as significant accounts during risk assessment.

When the engagement team investigates further, they determine that the lease payments correspond to leases that the client entered into during the fourth quarter and that the payment was inappropriately recorded directly into the miscellaneous expense account. Under the financial reporting framework, the leases should have been initially recorded on the balance sheet.

This represents a misstatement as the client did not apply the requirements of the financial reporting framework correctly.

Analysis

After additional investigation into the cause of the misstatement, the engagement team is able to understand the nature of the misstatement and why it occurred:

- the entity entered into lease agreements during the last quarter of the period and has not communicated that fact to the engagement team;
- management is not familiar with the requirements of the financial reporting framework for leases; and
- the misstatement does not appear to be the result of fraud.

Based on those facts, the engagement team identifies a new risk of material misstatement, which they link to several accounts, including lease related accounts and disclosures. Thus, they determine those accounts and disclosures are now significant accounts and disclosures.

In response to this new risk, the engagement team performs additional procedures, e.g. obtaining a complete list of lease agreements from the legal department, inspecting the lease agreements and determining that the leases were properly evaluated and correctly accounted for during the period.

The engagement team also expand their procedures on the miscellaneous expense account to determine whether there are other previously unknown leases or other liabilities.

In addition, the engagement team also considers the implications of management's lack of knowledge of lease accounting. A pervasive lack of management's competence indicates a financial statement level risk for which an overall response is necessary (e.g. increased supervision, increased professional skepticism, and pervasive changes to the nature, timing, or extent of audit procedures).

1.3 Evaluate whether misstatements are the result of fraud and the implications [ISA | 4457]

What do we do?

Evaluate whether the identified misstatements are or are likely to be the result of fraud AND if so, perform specific procedures to evaluate the implications.

Why do we do this?

Once we have determined that we have a sufficient understanding of the nature of an individual misstatement and the reason for which it occurred, we are in a better position to evaluate whether the identified misstatements are or are likely to be the result of fraud. When the misstatement is the result of fraud, the implications to our audit could be extensive.

Execute the Audit

What makes a misstatement fraudulent? [ISA | 4457.1300]

Misstatements in the financial statements can arise from either error or fraud. The distinguishing factor between the two is whether the underlying action is intentional or unintentional. Fraud is an intentional act.

Over what misstatements do we perform our evaluation of whether a misstatement indicates fraud? [ISA | 4457.1400]

Our evaluation of whether the misstatements indicate fraud is performed over all misstatements identified regardless of whether they are:

- not clearly trivial (i.e. accumulated in the SAM) or clearly trivial;
- related to a prior period or the current period; and
- misstatements in accounts or disclosures. Fraud could be committed not only in accounts but also by presenting incomplete or inaccurate disclosures or by omitting disclosures that are necessary for the financial statements to be fairly presented.

Do we perform our evaluation over misstatements individually or in aggregate? [ISA | 4457.1500]

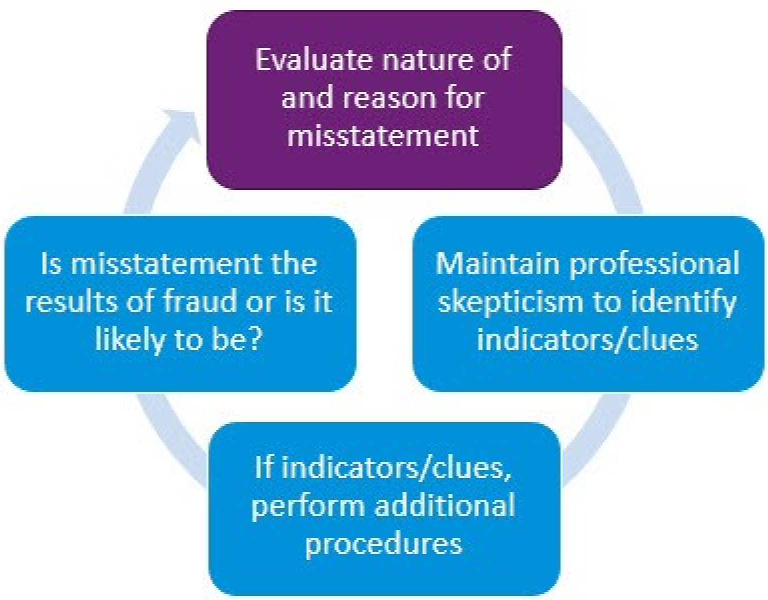
Both. In addition to evaluating whether the misstatements indicate fraud individually, we evaluate whether the misstatements indicate fraud in aggregate. Even though we consider all misstatements, even the ones that are clearly trivial, we do not accumulate misstatements that are clearly trivial in the SAM or anywhere else.

For example, identifying a number of misstatements - whether they are clearly trivial or not - within accounts in which we previously identified a fraud risk may indicate fraud.

How do we evaluate whether the identified misstatements are or are likely to be the result of fraud? [ISA | 4457.1600]

We evaluate whether the identified misstatements are or are likely to be the result of fraud when we are evaluating the nature of and reason for the misstatements. See activity 'Evaluate the nature of and reasons for the misstatements ' for information on this evaluation.

However, determining whether a misstatement is or is likely to be the result of fraud is not easy, so we follow the following process:



Once we have determined that we have a sufficient understanding of the nature of an individual misstatement and the reason for which it occurred, we are in a better position to evaluate whether the identified misstatements are or are likely to be the result of fraud.

Why may this evaluation be a challenging task and how do we try to overcome the challenge?

Evaluating whether the misstatements are or are likely to be the result of fraud may be a challenging task because management's intention may be difficult to determine.

In addition, the determination of whether fraud has occurred is a legal determination, which we, as auditors, are not qualified to make. We may never know for sure whether fraud has occurred, but at least we might have some indication that fraud is likely to have occurred.

That is why we exercise professional skepticism and remain alert for possible indications or clues that a misstatement may be the result of fraud.

Examples of possible indicators or clues are:

- missing documentation,
- the existence of fraud risk factors in the area in which we identified the misstatement,
- unsupported or unauthorized balances or transactions,
- inconsistent, vague, or implausible responses from management or employees,
- missing inventory or physical assets of significant magnitude,
- undue time pressures imposed by management to resolve the issues, and/or
- unusual delays by management in providing requested information.

The existence of these indicators and others, may tell us something about the possibility that the misstatement identified may be the result of fraud.

What do we do when there are indicators or clues that a misstatement may be the result of fraud?

When there are indicators or clues that a misstatement may be the result of fraud, we perform procedures to obtain additional audit evidence to determine whether fraud has occurred or is likely to have occurred.

If there are 'tip off laws', we take care not to tip management off while we perform the relevant procedures.

Examples of the procedures we may perform are:

- inquiring of management and employees (not suspected of perpetrating the fraud);
- inspecting additional documentation about the matter;
- performing additional procedures on the account or related accounts;
- involving KPMG specialists - e.g. Forensics in the Audit team; and/or
- inquiring of other departments in the entity outside of accounting (e.g. legal department).

All those procedures have a common goal, which is to understand the nature of the misstatement and the circumstances in which it occurred - i.e. the reason for the misstatement.

Example: Procedures performed when we determine that a misstatement might indicate fraud

Fact pattern

As part of the audit of the financial statements of PDL, we receive an accounts receivable confirmation back from a customer that indicates an exception. Although the entity's records show that an invoice to the customer was unpaid as of period end, the customer indicates that the invoice had already been paid.

Analysis

After investigating the incident further and considering the susceptibility of cash receipts to fraud - the entity receives checks on site -, we consider that the misstatement could indicate possible theft or misappropriation of assets.

As a result of discovering an indication that the misstatement might be intentional, we perform additional procedures to determine whether fraud has occurred or is likely to have occurred. These procedures include:

- informing client management, senior to the level of personnel involved in the exception, and asking them to investigate the matter further;
- inspecting additional records from the bank to obtain information about the customer payment;
- increasing the extent of our confirmation procedures and/or performing additional procedures over balances that are unpaid as of period end, which may help us to find out whether there are other invoices in the same situation; and
- involving forensics team members, depending on the situation and results of our additional procedures.

How do we evaluate the audit implications when we believe that a misstatement is or is likely to be the result of fraud? [ISA | 4457.1700]

When we believe that a misstatement is or is likely to be the result of fraud, there are additional procedures that we perform to evaluate the audit implications:

- We consider the fraudulent nature of the misstatement when evaluating the materiality of uncorrected misstatements and the related audit responses.
- We perform additional procedures if the effect on the financial statements could be material or cannot be readily determined.
- We evaluate the implications on the integrity of management or employees and the possible effect on other aspects of the audit, particularly the reliability of management representations.
- We re-evaluate our assessment of fraud risk and its effect on a) the nature, timing and extent of procedures and b) the effectiveness of controls.
- We evaluate whether the circumstances indicate possible collusion and, if so, its effect on the reliability of evidence obtained.
- We determine our responsibilities under fraud and illegal acts related standards and regulations.

While performing these procedures, we exercise professional skepticism.

The table includes additional information about these procedures:

Procedure	Additional information
We consider the fraudulent nature of the misstatement when evaluating the materiality of uncorrected misstatements and the related audit responses	Fraud is one of the qualitative factors that we take into account when evaluating whether a misstatement is material to the financial statements. Thus, we often consider misstatements resulting from fraud to be material, even when they are relatively small amounts, especially if management or senior management is involved.

<table>
<tr>
<td>If the effect on the financial statements could be material or cannot be readily determined, we perform additional procedures</td>
<td>When we believe that a misstatement is or is likely to be the result of fraud, sometimes we are able to determine how significant it is to the financial statements without difficulty. However, there are other times when the effect on the financial statements is not clear. In those situations, we perform additional procedures to better determine the full effect on the financial statements and the auditor's report.

For example:
• inquiring of management and employees;
• inspecting additional documentation about the matter;
• performing additional procedures on the account or related accounts;
• involving KPMG specialists - Forensics in the Audit team; and/or
• inquiring of other departments in the entity outside of accounting - e.g. legal department.

See Example below in this activity.</td>
</tr>
<tr>
<td>We evaluate the implications on the integrity of management or employees and the possible effect on other aspects of the audit, particularly the reliability of management representations</td>
<td>A misstatement that is or is likely to be the result of fraud may suggest that there are more pervasive issues, such as concerns with management's integrity. This is especially true when higher-level management is involved. Instances of fraud that involve higher-level management are more significant as there is a higher probability that the fraudulent activity may be more pervasive - i.e. not concentrated in just one area.

Fraud of this nature may call into question the reliability of audit evidence previously obtained because we may have doubts about the completeness and truthfulness of representations made to us and about the genuineness of accounting records and documentation.

If there are questions about the integrity of management, including concerns that the fraudulent activity may be more pervasive or involve higher-level management, we may:
• re-examine the audit evidence we previously obtained and determine whether it is still relevant and reliable;
• disclaim an opinion on the financial statements; and/or
• re-evaluate our client-continuance decisions and possibly withdraw from the engagement.</td>
</tr>
<tr>
<td>We re-evaluate our assessment of fraud risk and</td>
<td>Fraud is unlikely to be isolated. If a fraudulent activity occurred, it may indicate that there are others. There may also be other individuals in the entity that can rationalize the commitment of fraud.</td>
</tr>
</table>

its effect on a) the nature, timing and extent of procedures and b) the effectiveness of controls	When we perform our risk assessments at the beginning of the audit, we take into consideration all the information we have available at that moment. However, as we perform the audit and discover additional information, such as the fact that fraud has occurred or is likely to have occurred, adjustments to our fraud risk assessments may be necessary. Therefore, determining that a misstatement is or is likely to be the result of fraud may also cause us to reconsider whether our original fraud risk assessments are still appropriate. This is especially true when we identify fraud in an area in which we had not previously identified a fraud risk. Our re-evaluation of our fraud risk assessments may bring to light a new fraud risk or additional fraud risk factors that we had not previously identified or considered. When we identify additional fraud risks, we may decide to modify the nature, timing and extent of our substantive procedures to address the new risk. For example, we may determine that: • there is a financial statement level fraud risk, for which we might implement additional overall responses - e.g. incorporating an element of unpredictability, selecting items for testing that have lower amounts or are otherwise outside customary selection parameters, and/or increasing the persuasiveness of audit evidence obtained from our substantive procedures across the board; • there is a higher possibility of management override of controls, especially when we have concerns about management's integrity; or • there are fraud risk factors that we may not have previously identified, such as opportunity to commit fraud and an attitude/ rationalization for fraud. If this is the case, we consider whether these new fraud risk factors indicate the existence of new fraud risks, for which it may be necessary to modify our procedures. In addition, a misstatement is usually evidence of one or more control deficiencies. If the misstatement is or might be the result of fraud, there may be a breakdown of internal controls that allowed the fraudulent activity to occur. Therefore, fraud may bring into question our assessment of the effectiveness of controls, which may affect our control risk assessments.
We evaluate whether the circumstances	Fraud may be the result of collusion involving employees, management and/or external parties. An entity's internal controls usually include certain mechanisms, such as segregation of duties, to deter individuals

indicate possible collusion and, if so, its effect on the reliability of evidence obtained	from committing fraud. However, it is possible that two or more employees, notwithstanding the segregation of duties for example, decide to work together to circumvent the entity's internal controls to commit the fraudulent activity. Fraud that is the result of collusion may call into question the reliability of audit evidence previously obtained. In those situations, we may have doubts about the completeness and truthfulness of representations made to us and about the genuineness of accounting records and documentation. This depends on the nature of the collusion and how widespread it may be. If we are concerned about the reliability of audit evidence, our audit responses will vary depending on who is involved in the collusion - either management, employees or external parties. For example, we may: • re-examine the audit evidence we previously obtained and determine whether it is still relevant and reliable; • disclaim an opinion on the financial statements; and/or • re-evaluate our client-continuance decisions and possibly withdraw from the engagement.
We determine our responsibilities under fraud and illegal acts related standards and regulations	If fraud or another illegal act has occurred or is likely to have occurred, we have additional responsibilities under the auditing standards and other laws and regulations. If we become aware of possible illegal acts, we perform the procedures, as applicable, specified in activities: • Ascertain whether non-compliance with laws and regulations, including illegal acts, has occurred • Perform additional procedures if satisfactory information is not provided • Evaluate the possible effect of actual or suspected non-compliance, including illegal acts • US teams | Perform additional steps related to the entity's response • Non-US teams | Evaluate the entity's response to the non-compliance, including illegal acts • US teams | Perform additional procedures regarding governmental enforcement investigations • Communicate the actual, or suspected, instance of non-compliance, including an illegal act • Consider the effect on the auditor's report when non-compliance, including an illegal act, has or is likely to have occurred

- PCAOB & AICPA | Perform procedures when the modified audit report is not accepted
- Perform procedures when unable to determine whether non-compliance, including an illegal act, has occurred .

If we become aware of fraud, we perform the procedures, as applicable, specified in activities:

- Perform additional procedures when we identify or suspect a fraud
- Communicate fraud related matters .

Example: Additional procedures performed when we believe a misstatement is or is likely to be the result of fraud but we do not know how material its effect to the financial statements is

Fact pattern

During our audit of the financial statements of LDP, we learn that there was an incident at one of the entity's plants and the plant manager was terminated. When we inquire about the incident, we learn that the plant manager hired a friend to perform some construction work in the plant and purchased equipment from this friend over the past three years. Even though the invoices were paid (the payments were authorized by the plant manager), most of the improvements in the plant were not performed and the majority of the equipment was not delivered.

Analysis

This incident reveals a misstatement (property, plant and equipment that is recorded but does not exist) resulting from fraud, and the possible circumvention of controls over asset acquisitions. However, management and we do not know the actual effect of the fraud and how significant it is to the financial statements.

As a result, we perform additional audit procedures to determine the effect of the fraudulent activity on the financial statements. These procedures include:

- requesting management to perform a full investigation of the incident, including physically inspecting all the recorded property plant and equipment at the plant;
- performing observation procedures at the plant to determine whether the property plant and equipment exists;
- inspecting other vendors' invoices that were authorized or paid by the plant manager to determine whether fraud has been perpetrated through other vendors; and/or
- involving forensics team members.

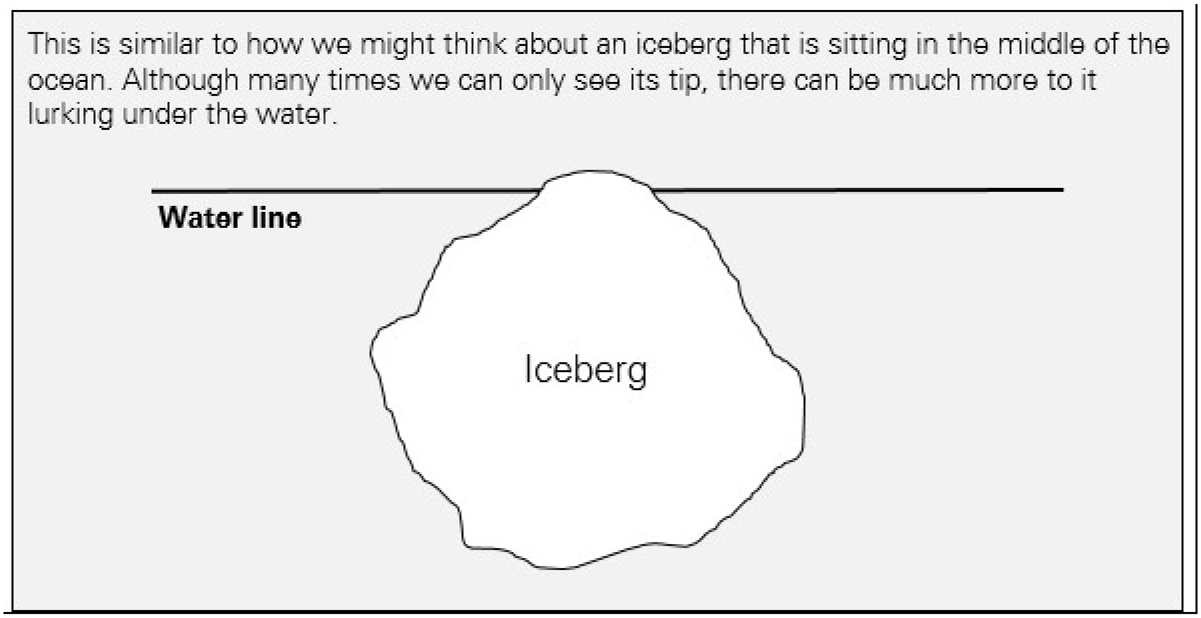
2 Consider the possibility of undetected misstatements and its implications [ISA | 4438]

What do we do?

Consider the possibility of undetected misstatements and its implications.

Why do we do this?

We consider the possibility of undetected misstatements and its implications because the existence of misstatements may indicate that there are other misstatements in the financial statements. We cannot assume that a misstatement is merely an isolated occurrence. Sometimes, a misstatement can be an indication that there is a bigger issue.



Execute the Audit

What are the 'undetected misstatements' in an audit? [ISA | 4438.1300]

The undetected misstatements are the misstatements that may exist in the financial statements but we do not detect in the audit.

Since we do not audit 100% of the financial statements, it is likely there are undetected misstatements. The fact that we use sampling techniques or we may not perform procedures in all of the accounts, disclosures and components of an entity increases the risk of undetected misstatements.

Why do we consider the risk of undetected misstatements? [ISA | 4438.1400]

Considering the risk of undetected misstatements helps us to determine whether we have reasonable assurance that the misstatements (detected and undetected) in the financial statements do not exceed the materiality level(s).

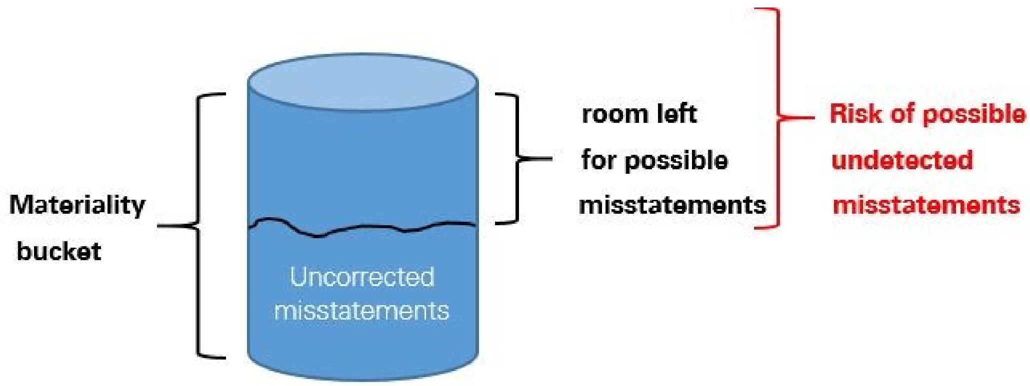
Let us think about the materiality level(s) as an empty bucket, and uncorrected misstatements as water that gets added into the bucket. When we have identified uncorrected misstatements, our materiality bucket fills up and has less room to take on more water - i.e. possible undetected misstatements. Therefore, we are concerned about the risk that our materiality bucket may overflow.

Thus, we carefully consider:

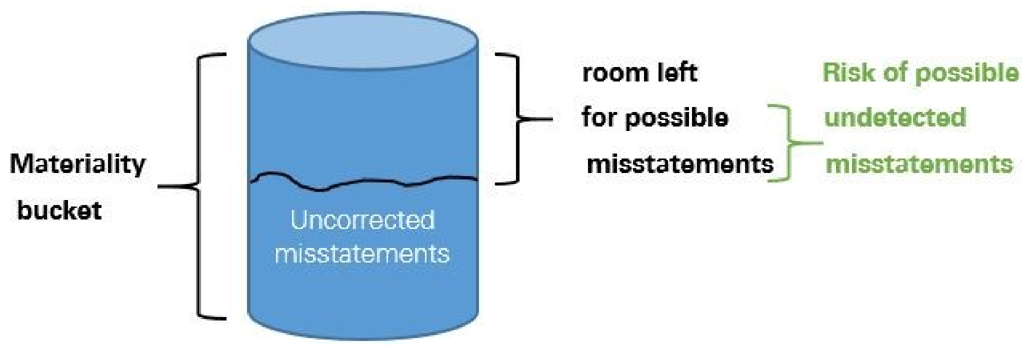
- how much 'room' we have left in the bucket - i.e. materiality amount less the total amount of uncorrected misstatements and

- the likelihood that additional water could be added - risk of possible undetected misstatements.

If there is little room left in the bucket - i.e. we have a large amount of uncorrected misstatements - or if there is an increased risk of possible undetected misstatements, there is a greater chance that the materiality bucket may overflow - i.e. a material misstatement may exist.



However, when there is a lot of room left in the bucket - i.e. we have a small amount of uncorrected misstatements - or when there is not a high risk of possible undetected misstatements, there is less of a chance that the materiality bucket could overflow.



When do we consider the possible undetected misstatements during the audit? [ISA | 4438.1500]

We consider the risk of undetected misstatements during planning and throughout the audit, especially if misstatements are identified.

When	Additional information
During planning	We consider the risk of undetected misstatements during planning when we establish performance materiality, which is what determines the amount of work we perform. We set up performance materiality based on our expectations of possible misstatements in the financial statements. As aggregation risk increases, performance materiality decreases. Aggregation risk is the risk that the undetected misstatements together with the uncorrected misstatements will exceed the materiality level(s).

Throughout the audit	During the audit, if misstatements are identified, we continue to think about the risk of possible undetected misstatements. If the level of identified misstatements and/or the risk of undetected misstatements increase during the audit beyond what we expected when we established performance materiality, it may mean that our expectations of possible misstatements in the financial statements during planning were inadequate. As a result, reducing performance materiality and/or modifying our overall audit strategy and audit plan - i.e. increasing the amount of work we do - may be necessary to obtain reasonable assurance that the financial statements are free of material misstatements.

What procedures do we perform during the audit to consider the possibility of undetected misstatements and its implications? [ISA | 4438.1600]

At its simplest, we consider the possibility of undetected misstatements and its implications through:

- considering the accumulated misstatements (i.e. corrected and uncorrected) and
- determining whether it is necessary to do more work.

Considering the accumulated misstatements (i.e. corrected and uncorrected) - procedures	Additional information
Determine whether the nature of *accumulated* misstatements and the circumstances of their occurrence indicate that other misstatements not yet detected might exist that, in combination with the accumulated misstatements, could be material.	This determination relates primarily to the nature of the misstatements and the circumstances in which they occurred (qualitative factors). It may be helpful to ask: Do the nature of and reason for the misstatements indicate that there are possible undetected misstatements that, individually or in combination with the accumulated misstatements, could be material? See activity 'Consider whether accumulated misstatements indicate undetected misstatements and its implications ' for further information.
Determine whether the aggregate of misstatements *accumulated* during the audit approaches the materiality level or levels used in planning and performing the audit.	This determination relates primarily to the amount of the misstatements (quantitative factor). If may be helpful to ask: Does the aggregated amount of misstatements *accumulated* in the SAM approach the materiality level(s) so that when aggregated together with the possible undetected misstatements, the total could be greater than the materiality level(s)?

	See activity 'Consider the aggregate of accumulated misstatements and its implications ' for further information.

In these determinations, we consider all *accumulated* misstatements (corrected and uncorrected), not only the uncorrected misstatements. Even if management corrects some or all the misstatements immediately,

- we cannot ignore that the misstatements existed and occurred for a reason; and
- those misstatements may still lead us to think that there could be an increased level of possible undetected misstatements.

Therefore, although management may correct some or all the misstatements, we still think about what the misstatements mean for our audit and how high the risk of possible undetected misstatements is.

Determining whether to do more work - procedure	Additional information
Determine whether it is necessary to modify our audit strategy and the audit plan	Depending on the results of the two determinations in the table above in this section, there may be an indication that aggregation risk - i.e. the risk that the undetected misstatements together with the uncorrected misstatements will exceed the materiality level(s) - is higher than we thought during planning. As a result, we may reduce performance materiality and/or modify our overall audit strategy and audit plan - i.e. increase the amount of work - to obtain reasonable assurance that the financial statements are free of material misstatements. See activity 'Consider whether accumulated misstatements indicate undetected misstatements and its implications ' and activity 'Consider the aggregate of accumulated misstatements and its implications ' for further information on how to determine whether it is necessary to modify our audit strategy and the audit plan.

2.1 Consider whether accumulated misstatements indicate undetected misstatements and its implications [ISA | 4439]

What do we do?

IF the nature of and reason for accumulated misstatements indicate that other misstatements might exist that, in combination with accumulated misstatements, could be material, THEN determine whether to modify the audit strategy and audit plan.

Why do we do this?

As we identify misstatements in our audit, we generally become more concerned about whether other misstatements may exist - i.e. the risk of possible undetected misstatements. If one or more of those possible undetected misstatements were material, individually or in combination with other misstatements, we might issue the wrong opinion.

Execute the Audit

How do we consider whether the nature of and reason for accumulated misstatements indicate undetected misstatements and whether it is necessary to modify the overall audit strategy and audit plan?

[ISA | 4439.1300]

There are several steps that we follow to perform this procedure:

Steps	Additional information
• Understand the nature of the *accumulated* misstatements (corrected and uncorrected) and the circumstances in which they occurred. See activity 'Evaluate the nature of and reasons for the misstatements ' for further information. • Consider what the misstatements tell us about the risk of possible undetected misstatements - i.e. the risk that misstatements exist but may not be detected in our audit	These considerations relate primarily to the nature of the misstatements and the circumstances in which they occurred (qualitative factors). In some cases, the cause of a misstatement may also be the cause of other misstatements that we have not identified yet. This may occur when a misstatement is the result of: • a breakdown in internal controls; • inappropriate assumptions or valuation methods that have been widely applied by the entity; • lack of competence of financial reporting personnel; or • another pervasive issue. It may be helpful to ask ourselves: Does the nature of the misstatement and the reason for its occurrence make us think that there could be other misstatements in the affected accounts or disclosures? Do we think that the misstatement is not isolated to the affected accounts or disclosures? Do we think that there is an increased risk that other related or similar areas in the financial statements may contain misstatements? Note that in these considerations, we take into account all *accumulated* misstatements (corrected and uncorrected), not only the uncorrected misstatements. Even if management corrects some or all the misstatements immediately, • we cannot ignore that the misstatements existed and occurred for a reason; and

	• those misstatements may still lead us to think that there could be an increased level of possible undetected misstatements. Therefore, although management may correct some or all the misstatements, we still think about what the misstatements mean for our audit and how high the risk of possible undetected misstatements is.
• If we think that undetected misstatements might exist, consider whether they, in combination with the *accumulated* misstatements (corrected and uncorrected), could be material	For this consideration, we also take into account all *accumulated* misstatements (corrected and uncorrected). The result of our consideration may be a concern that: • is specific to certain accounts - i.e. increased risk of possible undetected misstatements in a specific account or group of accounts; • could be broad, although less common - i.e. increased risk of possible undetected misstatements across all accounts; or • affects non-significant accounts or components for which we have not performed substantive procedures - i.e. if the misstatement identified is in a non-significant account or in one of those components.
• If we consider that the undetected misstatements, in combination with the *accumulated* misstatements, could be material, determine whether it is necessary to modify the overall audit strategy and audit plan to obtain audit evidence about whether the possible undetected misstatements actually exist.	If the possible undetected misstatements, in combination with the *accumulated* misstatements, could be material, there may be an indication that aggregation risk is too high for us to have reasonable assurance that the financial statements are free of material misstatement. In other words, the risk that the possible undetected misstatements together with the uncorrected misstatements exceed the materiality level(s) may be too high. As a result, we may modify our overall audit strategy and audit plan - i.e. increase the amount of work - to obtain reasonable assurance that the financial statements are free of material misstatements. Modifying our overall audit strategy and audit plan generally results in performing additional procedures to obtain audit evidence about whether the possible undetected misstatements actually exist. Depending on the circumstances, we may obtain additional audit evidence in a variety of ways: • in situations in which the risk is pervasive, we may perform additional substantive procedures throughout all significant accounts and disclosures to increase the overall persuasiveness of our audit evidence. We may accomplish this by decreasing performance materiality.

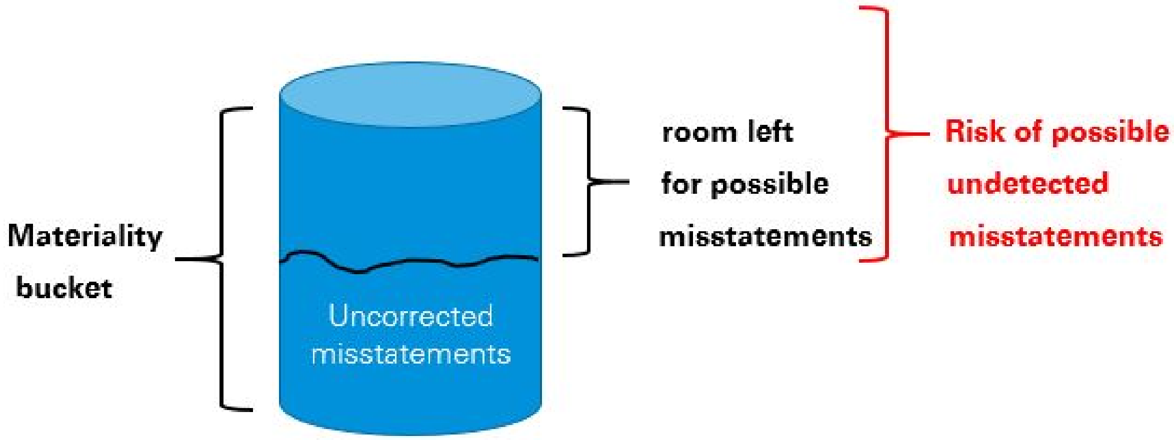
	• in situations in which we think the matter is limited to a few specific accounts or disclosures affected by the control deficiency(ies) that permitted the misstatement to occur, we may modify our substantive procedures over one or more accounts or disclosures. We may accomplish this by increasing our CAR assessments in those specific accounts or disclosures. • in situations in which the misstatement identified is in a non-significant account, we may perform substantive procedures over accounts or disclosures that we previously may not have identified as significant. This does not mean that it is necessary to identify additional RMMs. • in situations in which the misstatement identified is in a component where we may have originally decided not to perform procedures, we may perform substantive procedures for components where we may have originally decided not to perform procedures. This does not mean that it is necessary to identify additional RMMs. See question 'What do we consider when determining whether it is necessary to modify the overall audit strategy and audit plan? ' for information on what we consider when determining whether to modify the overall audit strategy and audit plan.

What do we consider when determining whether it is necessary to modify the overall audit strategy and audit plan? [ISA | 4439.1400]

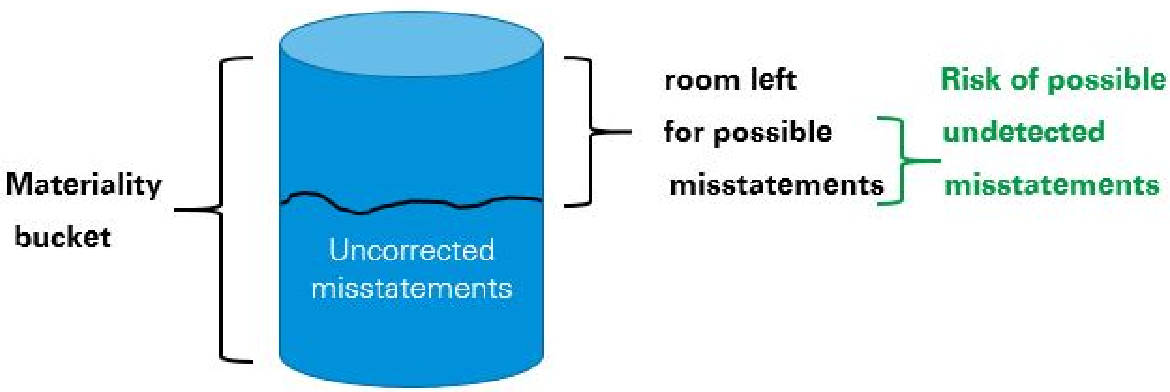
When the risk of possible undetected misstatements and/or aggregation risk is a concern, we may decide to perform additional procedures. Determining whether we perform additional substantive procedures and, if so, how much more work we perform depends on our assessment of aggregation risk. Its variables are:

- the amount of *uncorrected* misstatements and
- the level of risk of possible undetected misstatements.

When we determine that the risk of possible undetected misstatements is greater than the room left in the 'materiality bucket' (see question 'Why do we consider the risk of undetected misstatements? ' for information on the materiality bucket), we do not have reasonable assurance that the financial statements are free of material misstatement. Consequently, we perform additional substantive procedures for us to be satisfied that we can issue an unqualified opinion.



When we determine that the risk of possible undetected misstatements is less than the room left in the bucket, additional procedures may not be necessary.



In summary, the magnitude of these two variables - amount of uncorrected misstatements and risk of possible undetected misstatements - helps us to determine whether we perform additional substantive procedures and, if so, how much more work we perform to obtain reasonable assurance that the financial statements are not materially misstated.

Example

How does an engagement team consider the possibility of undetected misstatements? [ISA | 4439.1500]

Fact pattern

Entity JDP's financial statements contain several accounting estimates. During the audit, the engagement team identifies misstatements in two of those estimates.

Analysis

After investigating the cause of the misstatements, the engagement team determines that the errors stem from management's selection of inappropriate assumptions when they prepared those estimates.

As a result, the engagement team considers the other estimates (that they have not audited yet) for which management developed assumptions, and concludes that there is an increased risk of possible undetected misstatements in those estimates.

Those possible undetected misstatements, together with the accumulated misstatements, could be material.

Consequently, the engagement team decides to modify their audit procedures or perform additional procedures in those estimates to obtain more persuasive audit evidence.

2.2 Consider the aggregate of accumulated misstatements and its implications [ISA | 4440]

What do we do?

IF the aggregate of accumulated misstatements approaches the materiality level (or lower materiality level for particular accounts or disclosures), THEN determine whether to modify the overall audit strategy and audit plan.

Why do we do this?

The consideration of whether the aggregate of accumulated misstatements approaches the materiality level(s) provides us with an opportunity to think comprehensively about the level of misstatements detected and what that level means to our audit.

As we identify more misstatements in our audit, we generally become more concerned about whether other misstatements may exist that we could fail to detect in our audit (i.e. the increased risk of possible undetected misstatements). If one or more of those possible undetected misstatements were material, individually or in combination with other misstatements, we might issue the wrong opinion.

Execute the Audit

What do we think about when assessing whether the aggregate of accumulated misstatements approaches the materiality level (or lower materiality level for particular accounts or disclosures)? [ISA | 4440.1300]

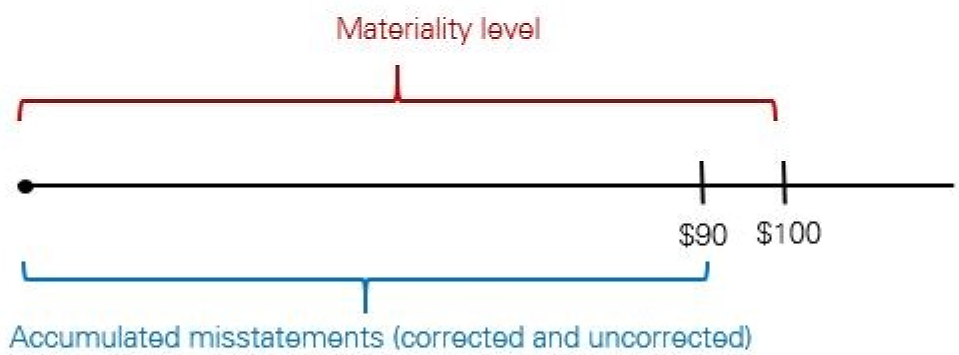
When assessing whether the aggregate of accumulated misstatements approaches the materiality level (or lower materiality level for particular accounts or disclosures), we think about all *accumulated* misstatements (corrected and uncorrected), not only the uncorrected misstatements. Even if management corrects some or all the misstatements immediately,

- we cannot ignore that the misstatements existed and occurred for a reason; and
- those misstatements may still lead us to think that there could be an increased level of possible undetected misstatements.

Therefore, although management may correct some or all the misstatements, we still think about what the misstatements mean for our audit and how high the risk of possible undetected misstatements is.

Our consideration of whether the aggregate of accumulated misstatements approaches the materiality level(s) relates primarily to the amount of the misstatements (quantitative factor).

This graphic depicts a scenario in which our accumulated misstatements start to approach the materiality level:



What do we look for when we consider whether the aggregate of accumulated misstatements approaches the materiality level (or lower materiality level for particular accounts or disclosures)? [ISA | 4440.1400]

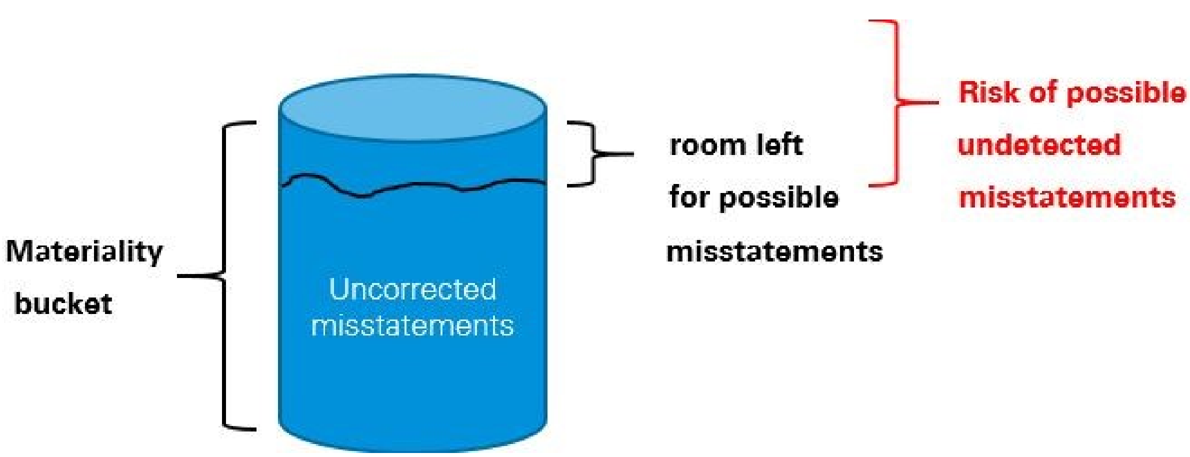
When we consider whether the aggregate of *accumulated* misstatements approaches the materiality level (or lower materiality level for particular accounts or disclosures), we look for indications that:

- there is a higher risk of possible undetected misstatements. When the *accumulated* misstatements approach the materiality level(s), the risk of possible undetected misstatements increases.

  We ask ourselves: 'If we identified this many misstatements, how many more are there that we have not identified yet?'

- there is a higher aggregation risk - i.e. the risk that the undetected misstatements together with the uncorrected misstatements will exceed the materiality level(s). The fact that the aggregate of accumulated misstatements approaches the materiality level(s) is an indication that aggregation risk is likely to be too high.

  Thinking back to the materiality bucket (see question '[Why do we consider the risk of undetected misstatements?](#)' for information on the materiality bucket), it is likely that we are in this scenario:



The level of non-significant accounts or components for which we have not performed substantive procedures may also have an effect on our consideration. We may ask ourselves: 'If we identified this many misstatements in significant accounts and certain components, how many more are there in non-significant accounts or components for which we have not performed substantive procedures?' 'Is the level of non-significant accounts or components for which we have not performed substantive procedures too high considering the fact that the misstatements identified are approaching the materiality level(s)?'.

What may the result of our consideration of the aggregate of accumulated misstatements indicate?

Our consideration may result in a concern that:

- is specific to certain accounts or disclosures if the misstatements identified suggest that there is a higher risk of possible undetected misstatements in specific accounts or disclosures - e.g. when misstatements are concentrated within one or two accounts or disclosures;
- is broad if the misstatements identified suggest that there is an increased risk of possible undetected misstatements across all accounts - e.g. when misstatements are across all accounts and disclosures in the financial statements;
- affects the non-significant accounts or the components for which we have not performed substantive procedures - e.g. when the level of non-significant accounts and components where substantive procedures have not been performed is too high considering the fact that the misstatements identified are approaching the materiality level(s).

What do we do when the level of undetected misstatements and/or aggregation risk is too high? [ISA | 4440.14435]

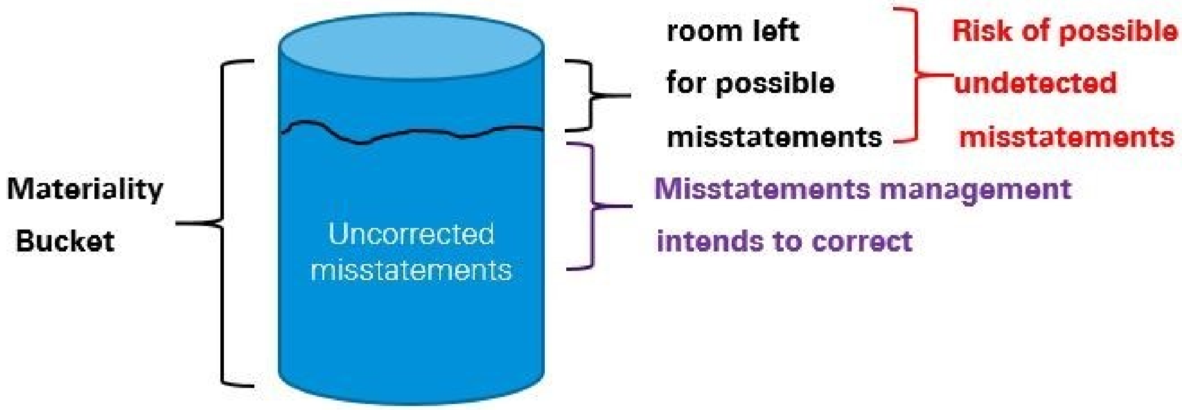
If there is a concern that the level of undetected misstatements and/or aggregation risk is too high, one or both of the following responses may be necessary:

- management may correct some or all of the uncorrected misstatements; and/or
- we may modify our overall audit strategy and audit plan to obtain additional audit evidence to determine whether the possible undetected misstatements actually exist.

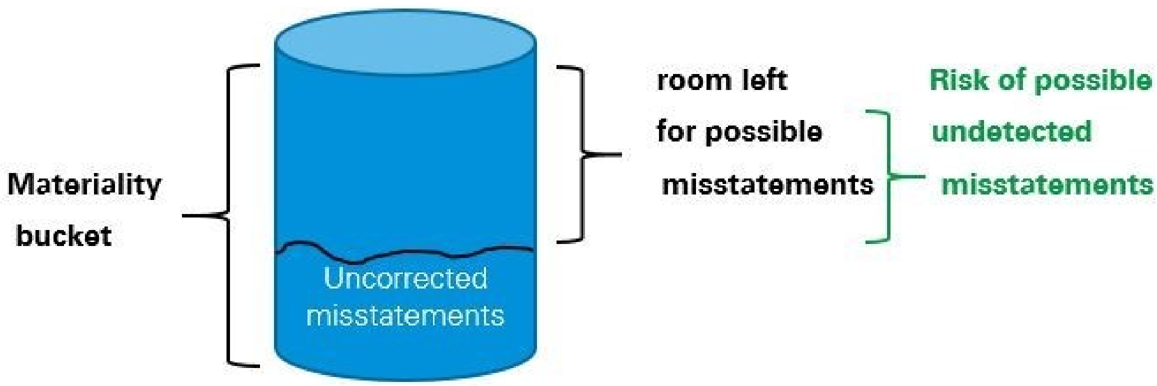
How does management's correction of misstatements affect the aggregation risk?

In some situations when our aggregation risk is too high, management may be able to reduce this risk by recording some or all of the uncorrected misstatements.

Thinking back to the 'materiality bucket' (see question 'Why do we consider the risk of undetected misstatements? ' for information on the materiality bucket), recording misstatements may let some of the water out of the bucket and cause the materiality bucket to be less full:



After management corrects some of the uncorrected misstatements, the risk that the possible undetected misstatements combined with the uncorrected misstatements are material may be reduced:



However, even when management corrects all of the uncorrected misstatements, we may still determine that the risk of possible undetected misstatements is too high if, for example, it is still greater than the room in the 'materiality bucket'. In such cases, we modify our overall audit strategy and audit plan to obtain additional audit evidence.

How do we modify our overall audit strategy and audit plan?

Modifying our overall audit strategy and audit plan generally results in performing additional procedures to obtain audit evidence about whether the possible undetected misstatements actually exist.

Depending on the circumstances, we may obtain additional audit evidence in a variety of ways:

- in situations in which the risk is pervasive, we may perform additional substantive procedures throughout all significant accounts and disclosures to increase the overall persuasiveness of our audit evidence. We may accomplish this by decreasing performance materiality.
- in situations in which we think the matter is limited to a few specific accounts or disclosures, we may modify our substantive procedures over one or more accounts or disclosures. We may accomplish this by increasing our CAR assessments in those specific accounts or disclosures.
- in situations in which the level of non-significant accounts and components where substantive procedures have not been performed is too high considering the fact that misstatements

identified are approaching the materiality level(s), we may perform substantive procedures over accounts or disclosures that we previously may not have identified as significant or we may perform substantive procedures for components where substantive procedures have not been performed. This does not mean that it is necessary to identify additional RMMs.

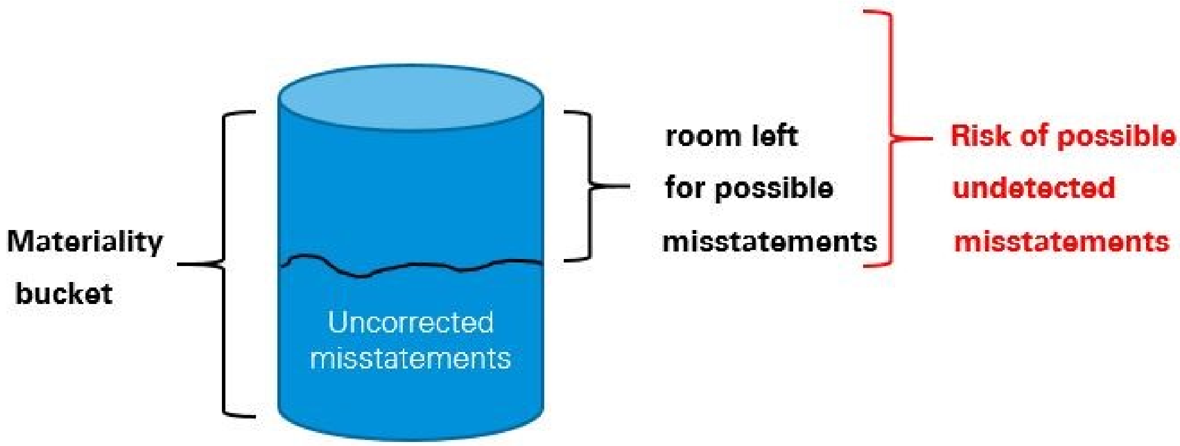
See question 'What do we consider when determining whether it is necessary to modify the overall audit strategy and audit plan? ' for information on what we consider when determining whether to modify the overall audit strategy and audit plan.

What do we consider when determining whether it is necessary to modify the overall audit strategy and audit plan?

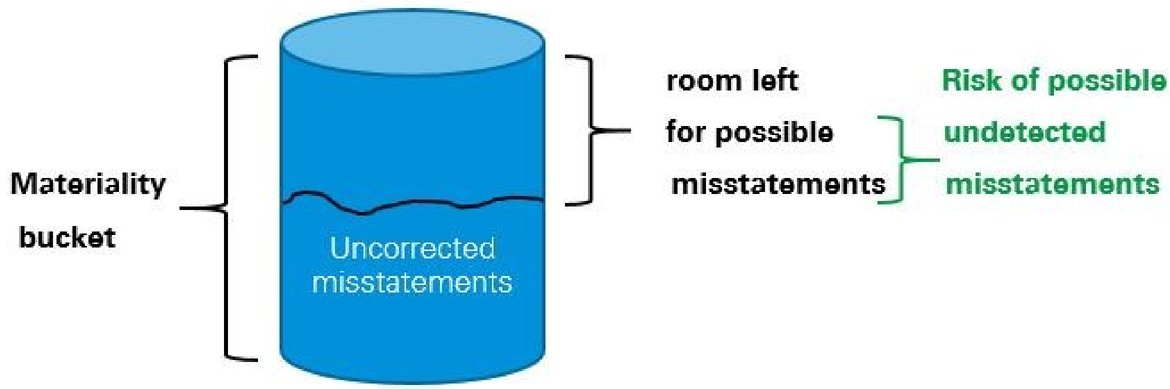
When the risk of possible undetected misstatements and/or aggregation risk is a concern, we may decide to perform additional procedures. Determining whether we perform additional procedures and, if so, how much more work we perform depends on our assessment of aggregation risk. Its variables are:

- the amount of uncorrected misstatements and
- the level of risk of possible undetected misstatements.

When we determine that the risk of possible undetected misstatements is greater than the room left in the 'materiality bucket' (see question 'Why do we consider the risk of undetected misstatements? ' for information on the materiality bucket), we do not have reasonable assurance that the financial statements are free of material misstatement. Consequently, we perform additional procedures for us to be satisfied that we can issue an unqualified opinion.



When we determine that the risk of possible undetected misstatements is less than the room left in the bucket, additional procedures may not be necessary.



In summary, the magnitude of these two variables - amount of uncorrected misstatements and risk of possible undetected misstatements - helps us to determine whether we perform additional procedures and, if so, how much more work we perform to obtain reasonable assurance that the financial statements are not materially misstated.

3 Evaluate management's examination of an account or disclosure in response to misstatements detected by us [ISA | 4442]

What do we do?

IF management examined an account or disclosure in response to misstatements detected by us and made corrections, THEN evaluate management's work.

Why do we do this?

When management examines an account or disclosure further in response to misstatements that we identified and makes corrections, we perform further procedures to obtain evidence that the revised account or disclosure is appropriately recorded.

Execute the Audit

Why does management examine an account or disclosure in response to misstatements that we identified? [ISA | 4442.1300]

Management examines an account or disclosure in response to misstatements that we identify because management is responsible for maintaining adequate support - books and records - for what is recorded in the financial statements. Thus, it is not appropriate for management to use our work papers or analysis as support for their accounts and adjustments recorded.

When management decides to record a misstatement, they follow their normal processes and procedures for recording entries and amounts in the financial statements, *including examining the account or disclosure* . By doing this, management is able to:

- understand the cause of the misstatements that we identified;
- determine the amount of the misstatements to be recorded in the financial statements; and
- obtain and maintain support for their financial statement accounts and the correcting entries.

In what specific situations does management usually examine an account or disclosure in response to misstatements that we identified? [ISA | 4442.1400]

Management usually examines an account or disclosure in response to misstatements that we identify in the following situations:

- when we identify a projected or judgmental misstatement.
  - in the case of a projected misstatement, management may need to perform their own procedures to analyze an account or disclosure - e.g. examining individual transactions - to determine the amount of the misstatement to correct.
  - in the case of a judgmental misstatement in an accounting estimate, management may need to review the assumptions and methods used in developing the estimate to determine the amount of the misstatement to correct.
- when we determine that the cause of a misstatement could be the cause of other misstatements in other accounts or disclosures, we may request management to further examine those specific accounts or disclosures that could also be affected.
- when we perform audit procedures on certain accounts or disclosures and determine that management has not recorded the transactions properly and several errors exist. In those situations, we may request management to further examine those accounts or disclosures and record necessary corrections before we finish performing our audit procedures over those accounts or disclosures.

What do we do when management has examined an account or a disclosure in response to misstatements detected by us and has made corrections to the account or disclosure? [ISA | 4442.1500]

If management has examined an account or a disclosure in response to misstatements detected by us and has made corrections to the account or disclosure, we evaluate management's work to determine whether:

- the corrections have been recorded properly; and
- uncorrected misstatements remain.

How do we evaluate management's work?

After management further examines the account or disclosure and makes the necessary corrections, we decide what procedures may be necessary to determine whether management's revised account balance or disclosure is appropriate.

Depending on the circumstances, this may include:

- determining whether management has identified the cause of the misstatement;
- obtaining an understanding of what management did to correct the account or disclosure, including reconciliations performed, and performing procedures over that work;
- inspecting the entries recorded to determine whether they were recorded in the financial statements correctly - i.e. the right entries have been made in the financial statements;

- determining whether, based on the examination performed by management, there are remaining uncorrected misstatements;
- re-performing our substantive procedures; and/or
- designing and performing additional substantive procedures to apply to the revised account and disclosure.

How do we treat the misstatements that management corrected or did not correct?

After we perform our audit procedures and are satisfied with the corrections recorded by management (whether or not they match our original misstatement(s)), we include the adjustment(s) recorded by management in the SAM - corrected misstatements section.

We include any remaining uncorrected misstatement(s) in the SAM - uncorrected misstatements section. Uncorrected misstatements may remain when:

- management does not record all the misstatements identified through their examination;
- we identify additional misstatements while performing our procedures over the revised accounts or disclosures; or
- we had identified a projected misstatement and management's procedures in response to that misstatement were less precise than our audit sampling procedure, which means that the difference between management's adjustment and our projection is still considered a misstatement.

If management's procedures are more precise than ours were, we may be able to conclude there is no remaining uncorrected misstatement(s).

Communication and Correction of Misstatements

International Standards on Auditing: ISA 450.08-09

Communication and Correction of Misstatements

8. The auditor shall communicate, unless prohibited by law or regulation, on a timely basis all misstatements accumulated during the audit with the appropriate level of management.[3] The auditor shall request management to correct those misstatements. (Ref: Para. A10 - A12)

3 ISA 260 (Revised), *Communication with Those Charged with Governance* , paragraph 7

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. A13)

ISA Application and Other Explanatory Material: ISA 450.A10-A13

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

A10. Timely communication of misstatements to the appropriate level of management is important as it enables management to evaluate whether the classes of transactions, account balances and disclosures are misstated, 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.

A11. In some jurisdictions, law or regulation may restrict the auditor's communication of certain misstatements to management, or others, within the entity. Law or regulation may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act, including alerting the entity, for example, when the auditor is required to report identified or suspected non-compliance with law or regulation to an appropriate authority pursuant to anti-money laundering legislation. In these circumstances, the issues considered by the auditor may be complex and the auditor may consider it appropriate to obtain legal advice.

A12. 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.

A13. ISA 700 (Revised) 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,[11] which may be affected by the auditor's understanding of management's reasons for not making the corrections.

11 ISA 700 (Revised), paragraph 12

How do we comply with the Standards? [ISA | KAEGHDWC]

1 Communicate accumulated misstatements to management and request their correction [ISA | 4441]

What do we do?

Communicate accumulated misstatements to management on a timely basis AND request management to correct those misstatements.

Why do we do this?

Management is responsible for the preparation and fair presentation of the financial statements.

We communicate accumulated misstatements to management on a timely basis to provide management with an opportunity to correct them. In addition, a two-way communication gives management an opportunity to provide us with further information and explanations.

We request the correction of misstatements so that management maintains accurate accounting books and records.

Execute the Audit

What are the benefits of timely communication and request for correction of misstatements? [ISA | 4441.1300]

Communicating misstatements to management and requesting their correction as soon as practicable after we identify them provides benefits to both management and us:

	Benefits of timely communication and request for correction
Management	• Enables management to make their own evaluation about whether the relevant accounts or disclosures are misstated and inform us if they disagree. • Allows management sufficient time to correct the misstatements, so they can a) maintain accurate accounting books and records and b) reduce the risks of material misstatement in future financial statements by eliminating the effect of prior-period misstatements in those future periods. • Provides management sufficient time to evaluate the cause of the misstatements and potential for additional misstatements. • Provides management the opportunity to evaluate whether one or more control deficiencies exist and to remediate them.
Us	• Facilitates earlier evaluation of the misstatements, including their nature and cause. • Helps to maintain a positive relationship with the entity as management may be frustrated if we do not bring up issues identified earlier in the audit until the end of the audit.

To whom do we communicate the misstatements and request their correction? [ISA | 4441.1400]

We communicate misstatements and request their correction to the appropriate level of management that has the responsibility and authority to evaluate the misstatements and to take action to correct them. This is usually the entity's Controller, Chief Accounting Officer (CAO) and/or Chief Financial Officer (CFO).

How do we communicate the misstatements and request their correction? [ISA | 4441.1500]

We may choose to communicate the misstatements and request their correction through ad-hoc meetings, or periodic meetings throughout the audit - e.g. once a week or once every two weeks.

Meeting with management and providing them with a draft of our SAM can help facilitate a more robust discussion about the nature of the misstatements.

What do we communicate to management regarding misstatements? [ISA | 4441.1600]

We usually communicate to management:

- the amount of the misstatements - known and/or estimated (i.e. projected misstatements and/or judgmental misstatements related to accounting estimates);
- the accounts and/or disclosures affected;
- information we know about the nature and circumstances of the misstatements; and
- other relevant factors, if any.

Can management correct the misstatements communicated by us using our work papers as support? [ISA | 4441.1700]

No. As management is responsible for maintaining adequate support - books and records - for what is recorded in the financial statements, it is not appropriate for management to use our work papers or analysis as support for their accounts and adjustments recorded.

Moreover, before recording a misstatement communicated by us, management may need to further examine an account or disclosure to determine the amount of the misstatement to correct, especially when the misstatement we identified is a projected or judgmental misstatement. See activity 'Evaluate management's examination of an account or disclosure in response to misstatements detected by us ' for further information about what we do when management further examines an account or disclosure in response to misstatements detected by us.

May law or regulation restrict our communication of certain misstatements? [ISA | 4441.1800]

Yes. In some jurisdictions, law or regulation may restrict our communication to management and/or those charged with governance of certain misstatements (or other related action) to avoid harming an investigation into an illegal act by an appropriate authority.

> For example, laws or regulations may specifically prohibit alerting the entity when we report to an appropriate authority in accordance with anti-money laundering legislation.

What do we do if law or regulation prohibits communicating misstatements? [ISA | 4441.14452]

When law or regulation restricts our communication of certain misstatements to management and/or those charged with governance, the engagement partner consults with the risk management partner.

2 Evaluate management bias in the selective correction of misstatements [ISA | 4460]

What do we do?

IF there are misstatements that management did not correct, THEN obtain an understanding of why management did not correct them.

Why do we do this?

Management's selective correction of misstatements may be an indicator of management bias. This concern increases when it appears there is a specific motive behind it, e.g. increasing revenue or income. However, the fact that management does not correct every misstatement does not necessarily mean there is bias. Obtaining an understanding of the reasons for which management did not correct a misstatement can help us to determine whether management bias actually exists.

Execute the Audit

How may management be biased in selectively correcting misstatements? [ISA | 4460.1300]

There are many ways management may be biased in selectively correcting misstatements, including by:

- correcting misstatements that have the effect of increasing reported earnings but not misstatements that have the effect of decreasing reported earnings - it may appear that management is biased to increase profitability;
- correcting only selected misstatements that have an offsetting effect or immaterial effect;
- correcting misstatements up to a certain date and refusing to make negative adjustments after that date - it may appear that management is biased for the profits not to go lower than a certain targeted level;
- correcting only those misstatements that do not affect metrics that are used by analysts and investors, for example revenues, EBITDA or other key operating ratios; and/or
- not correcting certain misstatements, including omissions, in prominent disclosures, for example revenue recognition, going concern, subsequent events or commitments and contingencies - it may appear that management is biased in how they present information particularly in sensitive financial statement disclosures.

What do we do if, after obtaining an understanding of why management did not correct misstatements, we determine that there is management bias in the selective correction of misstatements? [ISA | 4460.1400]

If, after obtaining an understanding of why management did not correct misstatements, we determine that there is management bias in the selective correction of misstatements, we:

- take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement. See activity 'Evaluate whether the bias is material to the financial statements and/or is the result of fraud ' for information about how we make this evaluation.
- evaluate the implications on our risk assessments, including fraud risk assessments. See activity 'Evaluate whether our risk assessments and the related audit responses remain appropriate ' for information about this evaluation.

Examples

How does an engagement team evaluate the selective correction of misstatements? [ISA | 4460.1500]

Scenario 1 **: Indication of management bias**

Fact pattern

In the audit of entity XYZ, the engagement team identifies several misstatements and communicates them to management. Management immediately corrects the misstatements that increase earnings but is unwilling to record the misstatements that decrease earnings.

Analysis

The engagement team inquires of management about why they refuse to record the identified misstatements. Management does not provide a rational explanation other than 'the misstatements are not material'. In the absence of any other reasons, this is likely an indication of management bias. As a result, the engagement team will then determine what additional procedures or responses are necessary as part of the audit.

Scenario 2: **No management bias**

Fact pattern

In the audit of entity ABC, the engagement team identifies several misstatements and communicates them to management. The engagement team realizes that management does not record certain misstatements that were communicated to them within 3 days of their proposed filing date.

Analysis

The engagement team investigates this and management explains that:

- they do not record adjustments that are immaterial within 3 days of their proposed filing date because of the administrative burden of changing all the information in the financial statements and the possibility of additional human error.
- if there is a potential material effect, they record all the misstatements identified, favorable and unfavorable, regardless of size.

The engagement team also:

- inspects management's evaluation of the misstatements where management considers whether the misstatements are material, individually or in combination with others; and
- concludes that their evaluation is reasonable.

Based on these circumstances, the engagement team concludes that there is not an indication of management bias in the selective correction of misstatements.

3 Evaluate management bias in the identification of offsetting adjustments [ISA | 4461]

What do we do?

IF management identifies adjusting entries that offset misstatements accumulated by us, **THEN** perform additional procedures.

Why do we do this?

We may encounter situations in which we communicate a misstatement to management during the audit and they identify an offsetting adjustment to neutralize its effect. Such circumstances may indicate management bias. Management may be trying to avoid recording certain misstatements to manipulate the financial statements. Furthermore, these situations may raise doubts about management's integrity and may indicate the existence of other undetected misstatements. Management may have identified other misstatements that they are not telling us about. They could be 'holding onto those adjustments' to offset further misstatements that we may identify during the remaining of the audit.

Execute the Audit

What procedures do we perform when management identifies offsetting misstatements? [ISA | 4461.1300]

We may encounter situations in which we communicate a misstatement to management during the audit and they identify an offsetting adjustment to neutralize its effect; such circumstances may indicate management bias. To help us evaluate the potential management bias and determine the effect on our audit, we perform additional procedures:

Procedures	Additional information
Perform procedures to determine why the underlying misstatements were not identified previously	The fact that management brings up offsetting misstatements does not necessarily mean there is bias. For example, management may be finalizing their analysis of the tax provision near the end of the audit. If we are aware of this fact and later management identifies a misstatement in the tax provision that offsets another misstatement that we identified, this may not represent management bias. We perform procedures to understand the reasons for which we were not aware of the offsetting misstatements. We may begin by inquiring of management. Based on management's responses, further audit procedures may be necessary to corroborate management's explanations or obtain further evidence. We then use this understanding to consider whether there is management bias.
Evaluate the implications on the integrity of management	If we believe management identified misstatements that were not disclosed to us timely, this might call into question management's integrity and the reliability of audit evidence previously obtained. We may have doubts about the completeness and truthfulness of representations made to us and about the genuineness of accounting records and documentation. If this is the case, we perform additional audit procedures necessary to resolve the matter and determine the effect, if any, on other aspects of the audit. See activity 'IF there are inconsistencies or doubts, THEN evaluate the effect on our audit ' for further information on this subject. For example, it may be necessary to:

	• re-examine the audit evidence previously obtained and consider whether it is truly relevant and reliable; • re-evaluate our client continuance decisions - i.e. withdraw from the engagement, if the matter cannot be resolved; or • disclaim our opinion.
Evaluate the implications on our risk assessments, including fraud risk assessments	If we believe management may have identified misstatements that they are not telling us about, we may consider that there are: • new risks of material misstatement, especially fraud risks, or • higher risks of material misstatement than we originally thought during planning. For example: • we may determine that there is a risk of material misstatement at the financial statement level, for which additional overall responses may be necessary (e.g. assign areas prone to bias to more senior level team members and/or increase the persuasiveness of audit evidence obtained from our substantive procedures); or • we may determine that there are fraud risk factors that we may not have previously identified, e.g. opportunity to commit fraud and an attitude/rationalization for fraud. If this is the case, we consider whether these new fraud risk factors indicate the existence of new fraud risks, for which it may be necessary to modify our procedures to address them.
Perform additional procedures as necessary to address the risk of further undetected misstatement.	If we believe that management may have identified misstatements that they are not telling us about and that, in combination with accumulated misstatements, could be material, we may consider modifying our audit strategy and audit plan by: • decreasing performance materiality, when the issue is pervasive (when we do this, additional audit procedures may be necessary), and/or • modifying the nature, timing and extent of audit procedures on a specific area, when the issue relates to a specific area of the audit. See activity 'Consider the possibility of undetected misstatements and its implications for further information on this subject.

In addition, exercising professional skepticism is essential in these situations.

When do we perform additional procedures if management identifies offsetting misstatements? [ISA | 4461.1400]

Although we evaluate the implications of management's offsetting misstatements while we evaluate the results of the audit, we also address these issues as they appear in the audit and do not necessarily wait until the end of the audit.

Example

How does an engagement team evaluate the implications of management's offsetting misstatements? [ISA | 4461.1500]

Fact pattern

During the audit of entity NRS, the engagement team identifies three misstatements, all of which overstate net income. They communicate the misstatements to management. Management records all of them. However, they also notify the engagement team that they have identified two other misstatements to reverse some expenses that have been recorded during the period but should have been recorded in the following period. These two misstatements significantly offset the effect of the three misstatements the engagement team identified.

Analysis

This is an indication of potential management bias. As a result, the engagement team performs procedures, e.g. inquiring of management, to understand why they were not previously made aware of the two additional adjustments.

The engagement team finds out that management was in the process of finishing some reconciliations and the timing of the two additional misstatements happened to coincide with the timing of the engagement team's communications. If there is evidence that supports management's explanation, further procedures are not necessary and the engagement team concludes that this situation is not the result of management bias.

However, if the engagement team determines that there is management bias and there may be additional misstatements that management is not disclosing to them, they may:

- identify additional risks of material misstatement in the audit and modify their audit procedures to address them;
- decrease performance materiality to address the risk of undetected misstatements; and/or
- determine whether their evaluation of management's integrity affect the reliability of audit evidence in general or their initial decisions related to client acceptance and continuance.

4 Evaluate whether the bias is material to the financial statements and/or is the result of fraud [ISA | 4468]

What do we do?

IF we identify - or we believe that there is - management bias, **THEN** evaluate whether the effect of management bias is material to the financial statements as a whole AND evaluate whether the bias is the result of fraud.

Why do we do this?

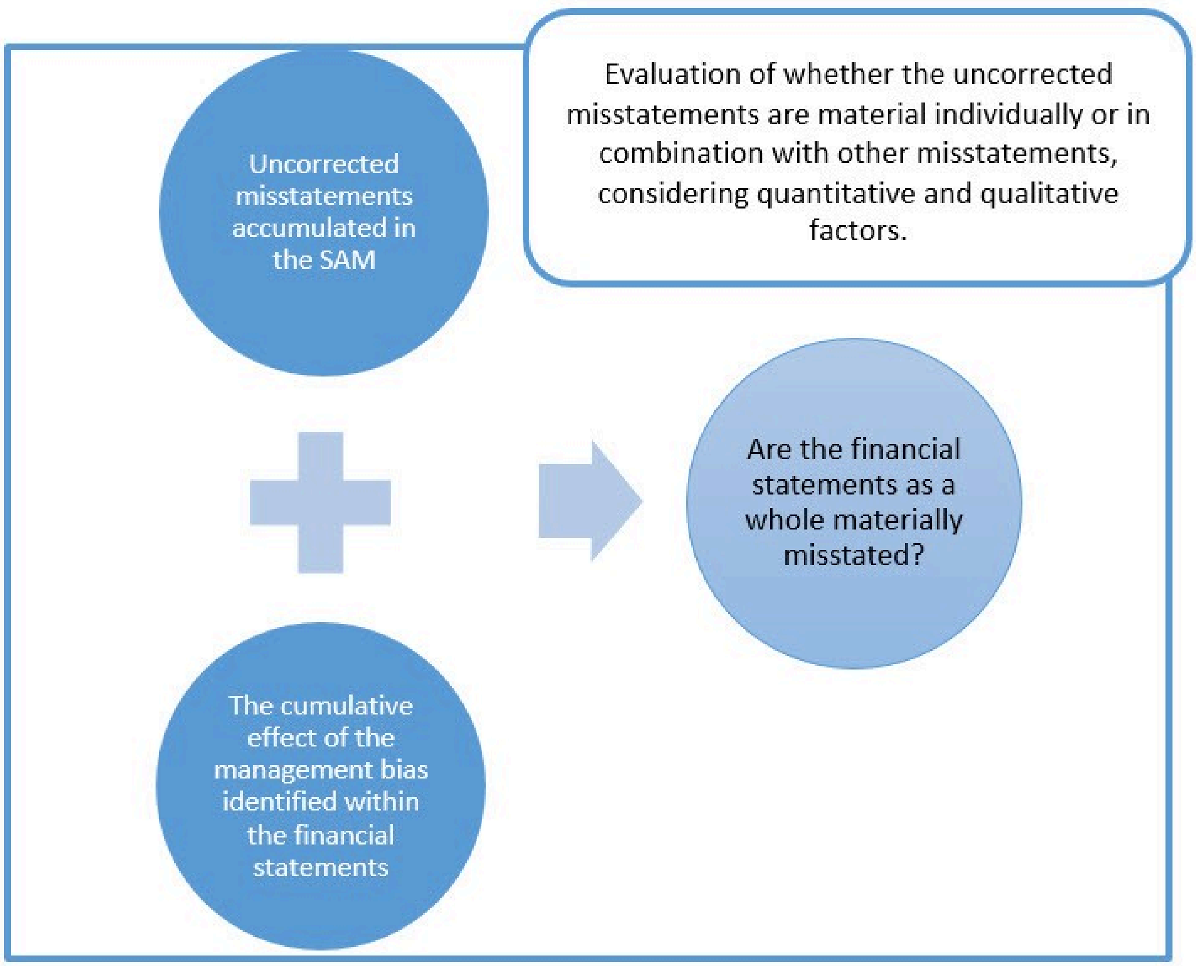
If we identify management bias, the effect of that bias may cause the financial statements to be materially misstated. In addition, if the bias represents fraud, there are additional implications for the audit.

Execute the Audit

How do we evaluate whether the effect of management bias is material to the financial statements as a whole and whether it is the result of fraud? [ISA | 4468.1400]

To evaluate whether the effect of the bias is material to the financial statements as a whole, we consider the uncorrected misstatements accumulated, including the cumulative effect of the management bias identified within the financial statements.

This evaluation can be different depending on whether the amount of the misstatement can be more easily determined. When we are unable to determine the amount of the misstatement generated from management bias, we estimate the cumulative effect of management bias identified in the financial statements.



To evaluate whether the bias is the result of fraud, we look for indicators of fraud. Activity 'Evaluate whether misstatements are the result of fraud and the implications ' includes useful information that may also apply to a situation in which the amount of the misstatement is not known.

This consideration becomes more relevant when there are many misstatements that are close to being material to the financial statements as a whole and when adding the effect of the bias in our evaluation, we realize that in combination with the other misstatements, it makes the financial statements materially misstated.

See activity 'Evaluate whether uncorrected misstatements are material and the implications ' for additional information on our evaluation of whether the uncorrected misstatements are material individually or in combination with other misstatements, considering quantitative and qualitative factors.

What amount does management record if they decide to correct the misstatement? [ISA | 4468.1600]

Management may choose to correct misstatements that result from bias that we identified. However, if bias exists in accounting estimates, additional analysis may be necessary for management to determine the appropriate amount to record and support their adjustment (see activity 'Evaluate management's examination of an account or disclosure in response to misstatements detected by us ' for further information about what we do when management further examines an account or disclosure in response to misstatements detected by us).

It is not appropriate for management to use our work papers or analysis as support for their estimates or adjustments recorded.

5 Evaluate whether our risk assessments and the related audit responses remain appropriate [ISA | 4469]

What do we do?

IF we identify indicators of bias or actual bias in management's judgments, **THEN** evaluate whether our risk assessments, including, in particular, the assessment of fraud risks, and the related audit responses remain appropriate.

Why do we do this?

If we identify indicators of bias or actual bias, there could be a risk of other biases, other issues in the financial statements or additional risks that we did not identify when we were planning the audit. This is particularly relevant when considering our fraud risk assessments, as the bias may be intentional and represent fraud.

Execute the Audit

How do we re-evaluate our risk assessments? [ISA | 4469.1300]

When we identify indicators of bias or actual bias, we re-evaluate our risk assessments. This includes not only the specific area (e.g. a specific account or disclosure) where the bias exists, but also other areas where similar biases could exist.

> For example, if we identify management bias in the warranty estimate, we re-evaluate our risk assessments not only for the warranty estimate, but also in other estimates and areas prone to bias.

See this activity for additional information about revising our risk assessment: 'Continue to assess RMMs, and revise audit approach as necessary '.

What is a common indicator of a higher risk of management bias in other areas of the financial statements?

The fact that management is aggressive with the selection and application of accounting principles/policies is an indicator that the risk of management bias in other areas may be higher.

Evaluating the Effect of Uncorrected Misstatements

International Standards on Auditing: ISA 450.10-11

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. A14 - A15)

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. A16 - A22, A24 - A25)

(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. A23)

ISA Application and Other Explanatory Material: ISA 450.A14-A25

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

A14. 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.

A15. 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.[12] 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.

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12 ISA 320, paragraph 12

A16. Each individual misstatement of an amount 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.

A17. In addition, each individual misstatement of a qualitative disclosure is considered to evaluate its effect on the relevant disclosure(s), as well as its overall effect on the financial statements as a whole. The determination of whether a misstatement(s) in a qualitative disclosure is material, in the context of the applicable financial reporting framework and the specific circumstances of the entity, is a matter that involves the exercise of professional judgment. Examples where such misstatements may be material include:

- Inaccurate or incomplete descriptions of information about the objectives, policies and processes for managing capital for entities with insurance and banking activities.
- The omission of information about the events or circumstances that have led to an impairment loss (e.g., a significant long-term decline in the demand for a metal or commodity) in an entity with mining operations.
- The incorrect description of an accounting policy relating to a significant item in the statement of financial position, the statement of comprehensive income, the statement of changes in equity or the statement of cash flows.
- The inadequate description of the sensitivity of an exchange rate in an entity that undertakes international trading activities.

A18. In determining whether uncorrected misstatements by nature are material as required by paragraph 11 of this ISA, the auditor considers uncorrected misstatements in amounts and disclosures. Such misstatements may be considered material either individually, or when taken in combination with other misstatements. For example, depending on the misstatements identified in disclosures, the auditor may consider whether:

(a) Identified errors are persistent or pervasive; or

(b) A number of identified misstatements are relevant to the same matter, and considered collectively may affect the users' understanding of that matter.

This consideration of accumulated misstatements is also helpful when evaluating the financial statements in accordance with paragraph 13(d) of ISA 700 (Revised), which requires the auditor to consider whether the overall presentation of the financial statements has been undermined by including information that is not relevant or that obscures a proper understanding of the matters disclosed.

A19. 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.[13]

13 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.

A20. 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.

A21. 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 to be included in the entity's annual report (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 (Revised)[14] deals with the auditor's responsibilities relating to other information.

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.

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14 ISA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*

A22. ISA 240[15] 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. Depending on the circumstances, misstatements in disclosures could also be indicative of fraud, and, for example, may arise from:

- Misleading disclosures that have resulted from bias in management's judgments; or
- Extensive duplicative or uninformative disclosures that are intended to obscure a proper understanding of matters in the financial statements.

When considering the implications of misstatements in classes of transactions, account balances and disclosures, the auditor exercises professional skepticism in accordance with ISA 200.[16]

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15 ISA 240, paragraph 36

16 ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing,* paragraph 15

A23. 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

A24. 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.

A25. 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.

How do we comply with the Standards? [ISA | KAEGHDWC]

1 Evaluate whether uncorrected misstatements are material and the implications [ISA | 4443]

What do we do?

Evaluate whether uncorrected misstatements are material and the implications.

Why do we do this?

The existence of material misstatements in the financial statements is one of the reasons that can prevent us from issuing an unqualified opinion. Therefore, if we fail to evaluate whether the uncorrected misstatements are material, we may issue an inappropriate unqualified opinion.

Execute the Audit

What is an uncorrected misstatement? [ISA | 4443.1300]

An uncorrected misstatement is a misstatement that is not clearly trivial - i.e. that we accumulated - and that management has not corrected.

Does our evaluation include all uncorrected misstatements? [ISA | 4443.1400]

Yes. Our evaluation includes all uncorrected misstatements that are not clearly trivial, regardless of:

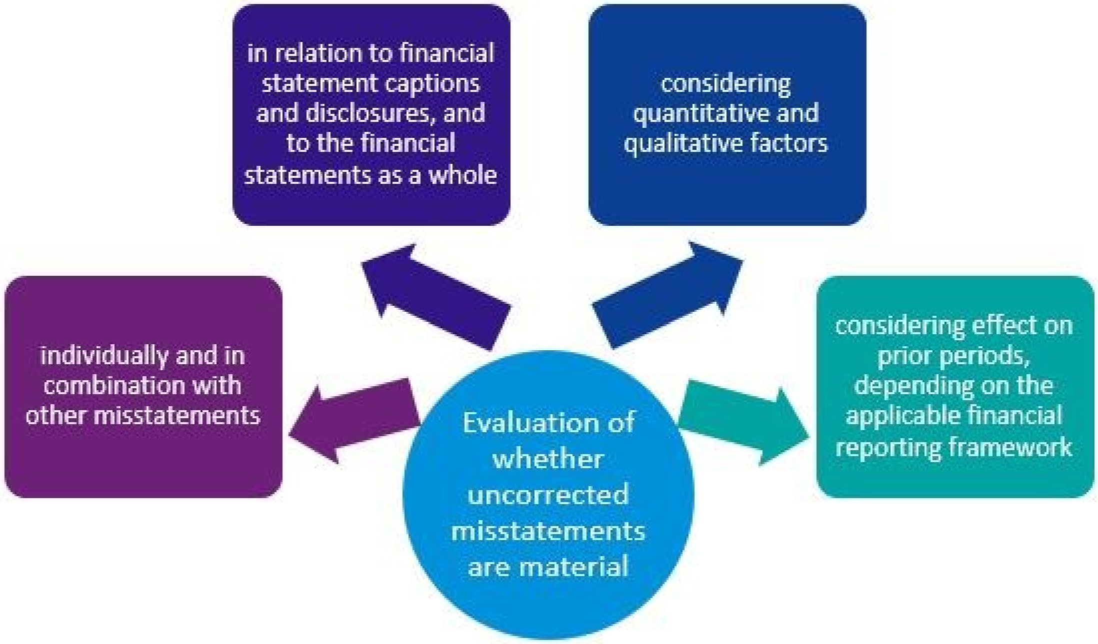
- the nature of the misstatement - e.g. misstatements in amounts or misstatements in narrative disclosures;
- who identified them - e.g. management, component auditors, or us;
- how they were identified - e.g. performing inquiries of management or performing test of details using a sample and extrapolating the error found; or
- whether they arose in the current period or prior periods.

Group Audit | Does the group auditor also evaluate uncorrected misstatements identified by component auditors? [ISA | 4443.14022]

Yes. The group engagement partner evaluates the effect on the group audit opinion of any uncorrected misstatements (whether identified by the group auditor or communicated by component auditors).

How do we evaluate whether the uncorrected misstatements are material? [ISA | 4443.14020]

In our evaluation of whether the uncorrected misstatements are material, we think critically about everything we know about the entity and the factors that we could reasonably expect to influence the economic decisions of users of the financial statements. We perform our evaluation as follows:



Misstatements are considered material if they could reasonably be expected to influence the economic decisions of financial-statement users. Therefore, size is just one of the characteristics of the misstatements we consider. This evaluation is not merely a simple numeric comparison, e.g. adding all misstatements and comparing the result to the materiality level for the financial statements as a whole. On the contrary, there are many facets as described in the graphic above.

What are the methods we use to quantify and evaluate the effect of uncorrected misstatements in the financial statements? [ISA | 4443.1600]

There are three methods auditors use to quantify and evaluate the effect of uncorrected misstatements on the financial statements:

- the Iron Curtain Method, also referred to as the 'balance sheet method';
- the Rollover Method, also referred to as the 'income statement method'; or
- the Dual Method. Under this method, the misstatements are analyzed under both the iron curtain and rollover methods.

In an audit conducted in accordance with the PCAOB standards, we use the dual method.

Group Audit | How does the group auditor evaluate uncorrected misstatements of the group financial statements? [ISA | 4443.1700]

We, as the group auditor, evaluate the uncorrected misstatements in the same way as we evaluate uncorrected misstatements in a stand-alone audit.

The group engagement partner's evaluation includes consideration of whether corrected and uncorrected misstatements communicated by component auditors indicate a systemic issue (e.g., regarding transactions subject to the same accounting policies or controls) that may affect other components.

What do we include in our audit documentation regarding our evaluation of uncorrected misstatements? [ISA | 4443.1800]

We document our conclusion as to whether uncorrected misstatements are material, individually or in combination with other misstatements, and the basis for that conclusion. The basis of the conclusion may cover all the facets of our evaluation mentioned in the graphic above, including when corrected and uncorrected misstatements communicated by component auditors indicate a systemic issue (e.g., regarding transactions subject to the same accounting policies or controls) that may affect other components.

What do we do if there is a material misstatement in the financial statements? [ISA | 4443.1900]

If there are uncorrected misstatements that are material to the financial statements, we express a qualified or adverse opinion, depending on the pervasiveness of the matter. The existence of a material misstatement in the financial statements is one of the reasons that can prevent us from issuing an unqualified opinion.

What activities do we perform to evaluate uncorrected misstatements? [ISA | 4443.14368]

To evaluate uncorrected misstatements, we perform the following activities:

- Confirm and take into account final materiality level(s)
- Determine the method to quantify and evaluate uncorrected misstatements
- Evaluate uncorrected misstatements individually and in combination with other misstatements
- Evaluate uncorrected misstatements taking into account quantitative and qualitative factors
- Evaluate the effect of prior-period uncorrected misstatements.

1.1 Confirm and take into account final materiality level(s) [ISA | 4444]

What do we do?

Confirm whether the materiality level(s) remain appropriate. IF the materiality level or levels were lowered, THEN take into account the lower level(s) of materiality in the evaluation of uncorrected misstatements.

Why do we do this?

We evaluate whether the uncorrected misstatements are material, keeping in mind the established materiality level or levels. We confirm whether the materiality level(s) remain appropriate because using the right materiality measures is essential in our evaluation of uncorrected misstatements. Toward the end of the audit, we have a final opportunity to determine that the materiality level(s) is set at an appropriate amount based on the circumstances of the audit.

Execute the Audit

When do we confirm that the materiality level(s) remain appropriate? [ISA | 4444.1300]

We confirm that the materiality level(s) remain appropriate toward the end of the audit prior to evaluating the effect of uncorrected misstatements.

As the audit progresses, the materiality level(s) is revised if we become aware of information that would have caused us to determine a different amount initially (see activity 'Determine whether to revise materiality and other materiality measures ' for further information). Therefore, any significant revision to the materiality level(s) is likely to have been made before we evaluate the effect of uncorrected misstatements. However, prior to that evaluation, we have a final opportunity to determine that the materiality level(s) is set at an appropriate amount based on the circumstances of the audit.

How do we re-establish the materiality level(s) toward the end of the audit, if necessary? [ISA | 4444.1400]

If necessary, we re-establish the materiality level(s) by performing activity 'Determine whether to revise materiality and other materiality measures '.

What is a common reason for which we may re-establish the materiality level(s) toward the end of the audit? [ISA | 4444.14453]

A common reason for which we may re-establish the materiality level(s) toward the end of the audit is if actual financial results (i.e. the figures that are going to be reported in the financial statements) differ significantly from those used to initially determine the materiality level(s).

What materiality level(s) do we take into account to evaluate uncorrected misstatements, if they were re-established? [ISA | 4444.14454]

If the materiality level(s) were re-established, we take into account the lower materiality level(s) to evaluate uncorrected misstatements. In other words, we use our most current determination of the materiality level(s) - final materiality level(s).

1.2 Determine the method to quantify and evaluate uncorrected misstatements [ISA | 4449]

What do we do?

Determine the method to quantify and evaluate the effect of uncorrected misstatements on the financial statements.

Why do we do this?

There are three methods available to quantify and evaluate uncorrected misstatements. We determine what method is the most appropriate based on the circumstances of the engagement.

Execute the Audit

What are the methods we use to quantify and evaluate uncorrected misstatements? [ISA | 4449.1300]

In practice, there are three methods auditors use to quantify and evaluate the effect of uncorrected misstatements on the financial statements:

- the Iron Curtain Method - also referred to as the balance sheet method;
- the Rollover Method - also referred to as the income statement method; or
- the Dual Method. Under this method, the misstatements are analyzed under both the iron curtain and rollover methods.

How do we determine the method to quantify and evaluate uncorrected misstatements? [ISA | 4449.1400]

We determine the method to quantify and evaluate the uncorrected misstatements based on the circumstances of the engagement. Factors we may consider when making this determination are:

- the method prescribed by laws or regulations. If the iron curtain method is required, we use either the iron curtain method or the dual method. If the rollover method is required, we use either the rollover method or the dual method.
- the method used in prior periods. Using the same method as the one used in prior periods provides consistency from period to period.
- whether management also uses a method to evaluate uncorrected misstatements. Using a different method to evaluate misstatements from management may create unnecessary issues. Management may reach an appropriate conclusion that a misstatement is not material under an acceptable method and we may be unwilling to agree only because we use a different method.

May we use a different method to quantify and evaluate uncorrected misstatements from the one used in the previous audit? [ISA | 4449.1500]

Not always. We may use a different method to quantify and evaluate uncorrected misstatements from the one used in the previous audit only if we change:

- from the rollover method to the iron curtain method or the dual method
- from the iron curtain method to the dual method.

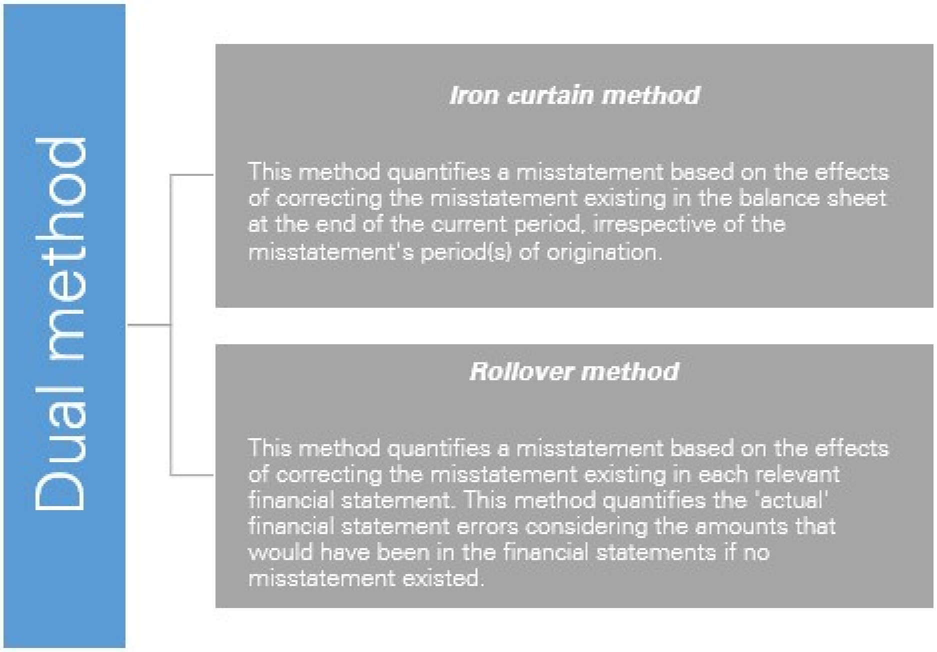
Prior period method	Current period method		
	Rollover method	Iron curtain method	Dual method
Rollover method		May change	May change
Iron curtain method	Cannot change		May change
Dual method	Cannot change	Cannot change	

This also applies when we are the successor auditor.

Do we consult when we intend to change the method to quantify and evaluate uncorrected misstatements from the one used in the previous audit? [ISA | 4449.1700]

It depends. When we intend to change the method to quantify and evaluate uncorrected misstatements and the change affects the conclusion on the materiality of uncorrected misstatements, we consult with DPP.

How do the methods work for quantifying and evaluating uncorrected misstatements? [ISA | 4449.1800]



The table below shows the effect of the misstatements in the balance sheet and income statement under each method:

Method	Balance sheet error	Income statement error
Iron curtain	The 'balance sheet error' under both methods is the amount by which the current-period balance sheet is misstated.	The 'income statement error' under the iron curtain method is the amount by which the current-period balance sheet is misstated.
Rollover		The 'income statement error' under the rollover method is the amount by which the current-period income statement is misstated.

This quantification is only the first step in the evaluation of the uncorrected misstatements to determine whether the financial statements are materially misstated.

After we quantify the misstatements, we include them in the SAM and evaluate them, individually and in combination with others, in relation to:

- the final materiality level(s) used in planning and performing the audit - i.e. final materiality level for the financial statements as a whole and any final lower materiality level for particular accounts or disclosures;
- the specific financial statement captions and disclosures involved; and
- the financial statements as a whole - i.e. subtotals and totals in all primary financial statements. With respect to the statement of cash flows, we evaluate the misstatements in relation to operating, investing and financing activities.

In this evaluation, we consider both quantitative and qualitative factors.

See activity 'Evaluate uncorrected misstatements individually and in combination with other misstatements' and activity 'Evaluate uncorrected misstatements taking into account quantitative and qualitative factors' for further information on this evaluation.

If, after our evaluation, the method used results in quantifying a misstatement that is material, individually and in combination with others, and after considering all relevant quantitative and qualitative factors, it is necessary to adjust the financial statements in accordance with the applicable financial reporting framework. In the case of the dual method, if either the iron curtain method or the rollover method results in quantifying a misstatement that is material, it is necessary to adjust the financial statements in accordance with the applicable financial reporting framework.

Example A shows how the methods work when there is a misstatement that has been building up over the past periods.

Example A: Explaining the difference between the iron curtain method, the rollover method and the dual method when there is a misstatement that has been building up over the past periods

Fact pattern

The entity is being provided a regular service for which it will pay $120 at the end of the 6-year contract. Management decided not to record the liability because they do not consider it material. Therefore, at the end of Period 5, the financial statements contain an understated liability of $100 that has built up over 5 years ($20 per period).

Period 1	Period 2	Period 3	Period 4	Period 5	Period 6	Total
$20	$20	$20	$20	$20	$20	$120

Analysis

- $20 is the misstatement that originated in the current period (Period 5)
- $80 is the amount of the misstatement that originated in the prior periods that remains uncorrected (Periods 1 - 4).

To evaluate the effect of the misstatement in the current period (i.e. Period 5), we quantify the misstatement depending on the method used:

Method	Quantification of the misstatement
Iron curtain method	Income statement effect (expenses): $100 (debit) Balance sheet effect (liability): $100 (credit) At the end of the Period 5, a $100 adjustment to the liability account is necessary to correctly state the balance

	sheet accounts. We do not consider the $80 effect on retained earnings at the beginning of the current period.
Rollover method	Income statement effect (expenses): $20 (debit) Balance sheet effect (liability): $100 (credit) Balance sheet effect (retained earnings) $80 (debit) At the end of the period 5, • an adjustment of $20 to increase expenses is necessary for the current period's income statement to be correct; and • a $100 adjustment to the liability account is necessary to correctly state the balance sheet accounts. The requirements of the various financial reporting frameworks with respect to the effect of prior-period misstatements are not the same. The $80 effect in retained earnings may not be considered when applying the requirements of some financial reporting frameworks. For simplification purposes, this example only includes the balance sheet and income statement effect. However, we also consider any other effect of the misstatement in the other primary financial statements and disclosures.
Dual method	We consider both the iron curtain method effect and the rollover method effect (see above in this table).

Once we quantify the misstatement using the appropriate method, we include the misstatement in the SAM and evaluate it individually and in combination with other misstatements, considering both quantitative and qualitative factors. In this evaluation, we consider the misstatements in relation to:

- the final materiality level(s) used in planning and performing the audit - i.e. final materiality level for the financial statements as a whole and any final lower materiality level for particular accounts or disclosures;
- the specific financial statement captions and disclosures involved; and
- the financial statements as a whole - i.e. subtotals and totals in all primary financial statements. With respect to the statement of cash flows, the engagement team evaluates the misstatements in relation to operating, investing and financing activities.

If the method used results in quantifying the misstatement as material, it is necessary to adjust the financial statements in accordance with the applicable financial reporting framework. In the case of the dual method, if either the iron curtain method or the rollover method results in quantifying a misstatement that is material, it is necessary to adjust the financial statements in accordance with the applicable financial reporting framework.

Note that the iron curtain method and the rollover method quantify the uncorrected misstatements that originate in prior periods differently. In this example, the effect of the misstatement that originated in the prior periods under the iron curtain method is $80 in the balance sheet and $80 in the income statement. However, its effect under the rollover method is $80 in the balance sheet only because such amount does not relate to the current-period income statement.

Example B shows how the methods work when there is a prior-period misstatement that has been corrected or has reversed in the current period.

Example B: Explaining the difference between the iron curtain method, the rollover method and the dual method when there is a prior-period misstatement that has been corrected or has reversed in the current period

Fact pattern

The entity is being provided a regular service for which it will pay $120 at the end of the 6-year contract.

Period 1	Period 2	Period 3	Period 4	Period 5	Period 6	Total
$20	$20	$20	$20	$20	$20	$120

Assume these two situations:

- 'Out-of-period' entry: Management did not record the liability in Period 1 through 4 because it was not material, but they recorded the $100 liability in Period 5. Although management has corrected the misstatement, there is still an uncorrected misstatement to evaluate in Period 5 under the rollover method related to the effect of the 'out-of-period' correction.
- Reversing entry: Management did not record the liability in Period 1 through 4 because it was not material. In Period 5, management settled the contract by paying $100 and recorded the payment as an expense. Although management made and recorded the payment, there is still an uncorrected misstatement to evaluate in Period 5 under the rollover method related to the reversing effect.

Analysis

The effect of the misstatements under the iron curtain method, the rollover method and the dual method in these two situations is the same:

Method	Quantification of the misstatement
Iron curtain method	No misstatement exists as the balance sheet is properly stated: • In the 'out-of-period' entry situation, the liability at period end is $100.

	• In the reversing entry situation, the liability at period end is $0.
Rollover method	Income statement effect (expenses): $80 (credit) Balance sheet effect (liability): $0 Balance sheet effect (retained earnings) $80 (debit) $80 is the misstatement that originated in the prior periods (Periods 1 - 4) that was recorded in the current period income statement (Periods 5) instead of being recorded in the proper prior period (Periods 1 - 4). An adjustment of $80 to decrease expense is necessary for the current period's income statement to be correct. The requirements of the various financial reporting frameworks with respect to the effect of prior-period misstatements are not the same. The $80 effect in retained earnings may not be considered when applying the requirements of some financial reporting frameworks. For simplification purposes, this example only includes the balance sheet and income statement effect. However, we also consider any other effect of the misstatement in the other primary financial statements and disclosures.
Dual method	We consider both the iron curtain method effect and the rollover method effect (see above in this table).

Once we quantify the misstatement using the appropriate method, we include the misstatement in the SAM and evaluate it individually and in combination with other misstatements, considering both quantitative and qualitative factors. In this evaluation, we consider the misstatements in relation to:

- the final materiality level(s) used in planning and performing the audit - i.e. final materiality level for the financial statements as a whole and any final lower materiality level for particular accounts or disclosures;
- the specific financial statement captions and disclosures involved; and
- the financial statements as a whole - i.e. subtotals and totals in all primary financial statements. With respect to the statement of cash flows, the engagement team evaluates the misstatements in relation to operating, investing and financing activities.

If the method used results in quantifying the misstatement as material, it is necessary to adjust the financial statements in accordance with the applicable financial reporting framework. In the case of the dual method, if either the iron curtain method or the rollover method results in quantifying a misstatement that is material, it is necessary to adjust the financial statements in accordance with the applicable financial reporting framework.

Note that the iron curtain method and the rollover method quantify the uncorrected misstatements that originate in prior periods differently. In this example, the effect of the misstatement that originated in the prior periods under the iron curtain method is $0 in both the balance sheet and the income statement. However, its effect under the rollover method is $80 in the income statement.

As we can see in the examples above, each method has its way of considering the effects of uncorrected misstatements. In the case of the dual method, both methods are part of our evaluation of the materiality of uncorrected misstatements.

When do we use these methods to quantify and evaluate uncorrected misstatements? [ISA | 4449.1900]

We use these methods to evaluate misstatements in any period, e.g. annual and interim.

1.3 Evaluate uncorrected misstatements individually and in combination with other misstatements [ISA | 4445]

What do we do?

Evaluate whether uncorrected misstatements are material individually or in combination with other misstatements.

Why do we do this?

Once the uncorrected misstatements are quantified, we evaluate them to determine whether they are material. As misstatements could be material not only individually but also in aggregate, our evaluation includes these two aspects. If we fail to evaluate one of the aspects, we might fail to detect material misstatements and issue the wrong opinion.

Execute the Audit

Why do we evaluate uncorrected misstatements individually and in combination with other misstatements? [ISA | 4445.1300]

We evaluate uncorrected misstatements in amounts and in disclosures individually and in combination with other misstatements because:

Why we evaluate misstatements individually and in combination with others	Real life example
If we evaluate the misstatements only in aggregate, we	Consider a situation in which a student gets an A in Math and a C in Language Arts. The student's average grade is a B. The student's report card indicates that she got a B in Math and a B in

might not notice that a misstatement by itself is material to the financial statements as a whole when, for example, it is offset by other misstatements.	Language Arts. Although the student's average grade remains the same, both the Math and the Language Arts grades are materially misstated. Those misstatements may lead to a misunderstanding in the student's performance in each of those classes, as well as in the consistency of the student's performance overall.  Similarly, in an audit, the fact that two material misstatements offset each other does not necessarily make them immaterial because two elements of the financial statements may be materially misstated. Those misstatements could lead to a user not to be able to understand the financial position of the entity correctly.
If we evaluate the misstatements only individually, we might not notice that a number of misstatements in aggregate might cause the financial statements as a whole to be materially misstated.	Consider a situation in which we are reading a book that has a few misprinted or missing words. Each misprint might not be a major concern if we are still able to understand the basic messages. However, if those small misprints add up to a significant amount or they relate to key words or paragraphs, they may impair our ability to understand the book.  Similarly, in an audit, the combination of misstatements in the financial statements could lead to a user not being able to understand the financial position of the entity correctly.

What does 'in combination with other misstatements' mean? [ISA | 4445.1400]

In combination with other misstatements' means that the misstatements are combined together in different ways based on the specific circumstances of the engagement. In doing this, we think about possible focus areas of financial statement users.

Combining all misstatements together is not the only combination possible. We also combine the uncorrected misstatements in ways that enable us to consider whether, in relation to subtotals and totals in the financial statements, including disclosures, they materially misstate the financial statements taken as a whole.

For example, we combine together uncorrected misstatements that affect the same:

- specific financial statement captions and disclosures
- subtotals in the financial statements. For example:
    - Balance Sheet: current assets, non-current assets, current liabilities and non-current liabilities.
    - Income Statement: gross income/margin, income from continuing operations and SG&A expenses.
    - Statement of Cash Flows: operating activities, financing activities and investing activities.
    - Statement of Changes in equity: other comprehensive income and additional paid-in capital.
- totals in the financial statements. For example: total assets, total liabilities and total net income(loss).
- qualitative characteristic. For example, misstatements that affect debt covenant calculations.
- matter. For example, a number of misstatements in disclosures that are relevant to the same matter, considered collectively, may affect the users' understanding of that matter.

Do we consider factual, projected and judgmental misstatements together in combination? [ISA | 4445.14485]

Yes. We consider misstatements in combination with each other, regardless of whether they are factual, projected or judgmental.

Example

How does an engagement team evaluate uncorrected misstatements in combination with other misstatements? [ISA | 4445.1500]

Fact pattern

During the audit of entity ABC's financial statements, the engagement team identifies several misstatements and communicates them to management. After performing its own analysis, the entity decides not to correct the misstatements because they are immaterial. Their analysis considered each amount individually and also the total effect of the misstatements on net income, neither of which is material.

Account affected by the misstatement	Amount of the misstatement DR / (CR)
Revenue	$25,000
Administrative expenses	($15,000)

Revenue	$7,500
Revenue	$20,000
Marketing expenses	($18,000)
Cost of goods sold	($19,000)
Effect on net income	**$500**

Analysis

As the engagement team evaluates the uncorrected misstatements, they observe that there are three misstatements that result in a $52,500 effect on revenue, which exceeds the final materiality level(s) used in planning and performing the audit and represents a significant effect to the revenue line item. These misstatements in combination represent a material misstatement, even though they are offset by other misstatements affecting other income statement accounts.

If the engagement team had focused on only the total effect of the misstatements on net income and not on other possible combinations, e.g. by financial statement line item, they might have missed the fact that the financial statements are materially misstated.

1.4 Evaluate uncorrected misstatements taking into account quantitative and qualitative factors [ISA | 4447]

What do we do?

Evaluate the uncorrected misstatements in relation to the specific financial statement captions and disclosures involved and to the financial statements as a whole, taking into account relevant quantitative and qualitative factors.

Why do we do this?

Misstatements are considered material if they could reasonably be expected to influence the economic decisions of financial-statement users. Therefore, when we evaluate uncorrected misstatements to determine whether they are material, we consider not only the amount of the misstatements (i.e. quantitative factors) but also qualitative factors that could affect how a reasonable financial-statement user views the financial information.

Execute the Audit

How do we consider quantitative factors when evaluating uncorrected misstatements? [ISA | 4447.1300]

When we think about quantitative factors, we focus on whether the amount/size of the misstatements, individually or in combination with others, are of such a magnitude that they are material to the financial statements. Considering quantitative factors entails:

- comparing the amount of the uncorrected misstatements with the final materiality level(s) used in planning and performing the audit; and
- comparing the amount of the uncorrected misstatements with:
  - the specific financial statement captions and disclosures involved and
  - the financial statements as a whole.

Considering quantitative factors	What does this mean?
Comparing the amount of the uncorrected misstatements, individually or in combination with others, with the final materiality level(s) used in planning and performing the audit.	The materiality level for the financial statements as a whole serves as an initial measure for determining when misstatements are quantitatively material. However, when we establish a lower materiality level for a particular account or disclosure, we consider that lower materiality level when evaluating whether misstatements that affect that particular account or disclosure are material.
Comparing the amount of the uncorrected misstatements, individually or in combination with others, with: • the specific financial statement captions and disclosures involved and • the financial statements as a whole.	Comparison with specific financial statement captions and disclosures We perform this evaluation because there may be misstatements of an amount less than the final materiality level(s) that may still be material in relation to a specific financial statement caption or disclosure. For example, we may identify misstatements in the income tax expense account that represent 200% of the line item. Those misstatements may be less than the final materiality level for the financial statements as a whole (used in planning and performing the audit) but may be material in relation to the income tax expense line item. This is especially true if we established a lower materiality level for the income tax expense account during planning and the total amount of the misstatements is greater than the lower materiality level. Comparison with the financial statements as a whole When we perform this evaluation, we evaluate the uncorrected misstatements in relation to totals and/or subtotals in all the primary financial statements - e.g. balance sheet, income

	statement, statement of cash flows and statement of changes in equity. With respect to the statement of cash flows, we evaluate the misstatements in relation to operating, investing and financing activities.

How do we consider qualitative factors when evaluating uncorrected misstatements? [ISA | 4447.1400]

When we think about qualitative factors, we focus on factors that are not related to the amount of the misstatements but could affect how a reasonable financial-statements user views the financial information. The qualitative factors relate to the nature of the misstatements and the circumstances of their occurrence.

Consider a situation in which we are reading a book that has a few misprinted or missing words. If we find that there are only two small misprints, they may not be a significant issue. However, if one of those misprints is that the final two sentences of the book are missing, it may significantly affect a key element of the story - the ending.

Similarly, some misstatements may have a significant effect on the financial statements, even if their amount is quantitatively small.

We evaluate whether the unrecorded misstatements are qualitatively material, individually or in combination with others, in relation to:

- the specific financial statement captions and disclosures involved, and

For example, we may identify misstatements in the income tax expense account. Those misstatements may be less than the final materiality level(s) but may be qualitatively material in relation to the income tax expense account if the misstatements significantly change the entity's effective tax rate because the government monitors the effective tax rate and may change its decisions as a result.

- the financial statements as a whole.

For example, we may identify misstatements in multiple accounts. Those misstatements may not be quantitatively material with respect to totals and subtotals in the financial statements but may be qualitatively material because they may affect some common qualitative characteristic - e.g. multiple misstatements affecting certain debt covenant calculations.

In what area are qualitative factors particularly relevant?

Qualitative factors can be particularly relevant when we are evaluating misstatements within narrative disclosures. A misstatement in a narrative disclosure could represent information that is misstated or omitted from a disclosure - e.g. management's failure to disclose the estimated loss that has been accrued for a loss contingency.

Examples of when the misstatements in narrative disclosures may be material include:

- the omission of information about the events or circumstances that have led to an impairment loss (e.g. a significant long-term decline in the demand for a metal or commodity) in an entity with mining operations;
- the incorrect description of an accounting policy related to a significant item in the balance sheet, the income statement, the statement of changes in equity or the statement of cash flows; or
- the inadequate description of the sensitivity of an exchange rate in an entity that undertakes international trading activities.

What qualitative factors do we consider in our evaluation of the materiality of uncorrected misstatements?

The qualitative factors we consider, if relevant, in our evaluation of the materiality of uncorrected misstatements include:

- the potential effect of the misstatement on trends, especially trends in profitability;
- a misstatement that changes a loss into income or vice versa;
- the effect of the misstatement on segment information, for example, the significance of the matter to a particular segment important to the future profitability of the entity, the pervasiveness of the matter on the segment information, and the impact of the matter on trends in segment information, all in relation to the financial statements taken as a whole;
- the potential effect of the misstatement on the entity's compliance with loan covenants, other contractual agreements, and regulatory provisions;
- the existence of statutory or regulatory reporting requirements that affect materiality thresholds;
- a misstatement that has the effect of increasing management's compensation, for example, by satisfying the requirements for the award of bonuses or other forms of incentive compensation;
- the sensitivity of the circumstances surrounding the misstatement, for example, the implications of misstatements involving fraud and possible illegal acts, violations of contractual provisions, and conflicts of interest;
- the significance of the financial statement element affected by the misstatement, for example, a misstatement affecting recurring earnings as contrasted to one involving a non-recurring charge or credit, such as an extraordinary item;
- the effects of misclassifications between certain account balances affecting items disclosed separately in the financial statements, for example, misclassification between operating and non-operating, income or recurring and non-recurring income items;
- the significance of the misstatement or disclosures relative to known user needs, for example:

  - the significance of earnings and earnings per share to entity investors;
  - the magnifying effects of a misstatement on the calculation of purchase price in a transfer of interests (buy/sell agreement); or
  - the effect of misstatements of earnings when contrasted with user expectations (based on our understanding of known previous communications to users, for example, in relation to forecast earnings);

- the definitive character of the misstatement (i.e. factual vs judgmental misstatements);
- the motivation of management with respect to the misstatement, for example,

  - an indication of a possible pattern of bias by management when developing and accumulating accounting estimates; or
  - a misstatement precipitated by management's continued unwillingness to correct weaknesses in the financial reporting process;

- the existence of offsetting effects of individually significant but different misstatements;
- the likelihood that a misstatement that is currently immaterial may have a material effect in future periods because of a cumulative effect, for example, that builds over several periods;
- the cost of making the correction-it may not be cost-beneficial for the entity to develop a system to calculate a basis to record the effect of an immaterial misstatement. On the other hand, if management appears to have developed a system to calculate an amount that represents an immaterial misstatement, it may reflect a motivation of management with respect to the misstatement as indicated in a bullet above.
- the risk that possible additional undetected misstatements would affect our evaluation;
- the effect of the misstatement on ratios used to evaluate the entity's balance sheet, income statement or statement of cash flows;
- a misstatement that relates to items involving particular parties, including related party transactions;
- a misstatement that is an omission of information not specifically required by the applicable financial reporting framework but which, in our judgment, is important to the users' understanding of the balance sheet, income statement or the statement of cash flows of the entity;
- a misstatement that affects the other information to be included in the entity's annual report that may reasonably be expected to influence the economic decisions of the users of the financial statements.

Do we consider the effect of uncorrected misstatements in future periods?

Yes. A forward looking consideration is one of the qualitative factors we consider in our evaluation of the materiality of uncorrected misstatements.

Even when uncorrected misstatements are not material in the current period, we still consider whether those misstatements could be material in future periods.

> For example, an entity is being provided a regular service for which it will pay $120 at the end of the 6-year contract. Management decided not to record the liability because they do not consider it material. Therefore, at the end of Period 5, the financial statements contain an understated liability of $100 that has built up over 5 years ($20 per period).

> If the $100 misstatement is not material in Period 5 but we expect that it could be material in relation to the Period 6's financial statements, it is prudent for management to correct the misstatement of $100 in the current period (i.e. Period 5).

Recording identified misstatements timely prevents possible issues in future periods. For example:

- depending on the applicable financial reporting framework, it may be necessary to perform future adjustments to prior-period financial statements (e.g. in certain circumstances, US GAAP requires an immaterial correction of an error in prior-period financial statements);
- the cumulative effect of prior-period uncorrected misstatements may affect our determination of aggregation risk and performance materiality in future periods - affecting our audit approach. This is particularly true when uncorrected misstatements approach the materiality level(s) used in planning and performing the audit.

How do the quantitative and qualitative factors interact when evaluating uncorrected misstatements? [ISA | 4447.14384]

Due to the interaction of quantitative and qualitative considerations in materiality judgments, we evaluate those factors together and may determine that a misstatement is:

- material, individually or when considered together with other misstatements, even if it is not quantitatively material; or
- not material, individually or when considered together with other misstatements, even if it is quantitatively large.

In each situation we encounter, we perform a thoughtful analysis of all the facts and circumstances before reaching a conclusion. This table shows a few examples of possible scenarios we may encounter for these two situations:

	Examples of possible situations we may encounter
Misstatements may be considered material even if they are not quantitatively material	• An illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue. • A relatively small misstatement could be material if it was made intentionally (i.e. fraud). • A misclassification between balance sheet financial statement captions that is a small amount in relation to the size of the related balance sheet financial statement captions may be material if the misclassification affects a key ratio. • A small misstatement may be considered material if it affects a disclosure that has a history of causing volatility in the price of an entity's securities - e.g. earnings per share. • A couple of misstatements within the same account that, when evaluated in aggregate, offset each other, may be considered material if they affect presentation and/or disclosures in the financial statements.

	• A misstatement in revenue that is not quantitatively material may be material if it changes the trend in revenues (from decreasing to increasing) and that trend is important to the financial-statements users.
Misstatements may be considered immaterial even if they are quantitatively material	• A classification misstatement that exceeds the materiality level(s) may be not material, if the misclassification: - is small in relation to the size of the individual line items or subtotals in the financial statements; - does not affect key ratios; and - does not affect debt-covenant calculations.

1.5 Evaluate the effect of prior-period uncorrected misstatements [ISA | 4450]

What do we do?

Evaluate the effect of prior-period uncorrected misstatements - detected in prior periods and in the current period - in accordance with the applicable financial reporting framework.

Why do we do this?

We consider the effect of the prior-period uncorrected misstatements in the current-period evaluation of the uncorrected misstatements because those prior-period misstatements may affect our conclusion about whether the current-period financial statements are materially misstated.

Furthermore, they may have implications to the evaluation of prior-period financial statements, depending on the applicable financial reporting framework, that may result in the withdrawal of our previously issued auditor's reports.

Execute the Audit

How may the prior-period uncorrected misstatements affect the current-period and the prior-period financial statements? [ISA | 4450.1300]

The effect of the prior-period uncorrected misstatements may:

- be material to the current-period financial statements; and
- have implications to the evaluation of prior-period financial statements (i.e. it may be necessary to correct the prior period financial statements, depending on the applicable financial reporting framework).

> For example, in accordance with US GAAP, it may be necessary to:
>
> - restate the prior-period financial statements; and/or

- perform an immaterial correction of an error in the prior-period financial statements (also referred to as "little R").

US GAAP | What are the main differences between a restatement and an immaterial correction of an error? [ISA | 4450.14488]

	Restatement	Immaterial correction of an error
Are the misstatements material to the prior-period financial statements?	Yes	No
When is the timing of the revision?	As soon as practicable	When the financial statements are next presented (e.g. 2018 financial statement amounts included in the 2019 financial statements issuance).
Do we amend our auditor's report?	Yes	No

Not US GAAP | How do we evaluate the effect of prior-period uncorrected misstatements? [ISA | 4450.14489]

We evaluate the effect of prior-period uncorrected misstatements by following the requirements of the applicable financial reporting framework.

In addition, in the case of prior-period uncorrected misstatements detected in the current period, we follow the relevant procedures for when we have a subsequent discovery of facts. See chapter on subsequent events (AU-C 560, ISA 560) for information on these procedures.

As indicated in those chapters, if we are considering a restatement of prior-period financial statements, we consult. See activity 'Consult with the appropriate parties in certain circumstances' for further information on consultation requirements.

US GAAP | How do we evaluate the effect of prior-period uncorrected misstatements in accordance with US GAAP? [ISA | 4450.14491]

We evaluate the effect of prior-period uncorrected misstatements in accordance with US GAAP by performing the following activities:

- evaluate prior-period uncorrected misstatements detected in prior periods;
- evaluate misstatements detected in the current period that relate to prior periods;
- consult regarding immaterial corrections of errors if applicable.

In the case of prior-period uncorrected misstatements detected in the current period, we also follow the relevant procedures for when we have a subsequent discovery of facts. See chapter on subsequent events (AU-C 560, ISA 560) for information on these procedures.

As indicated in those chapters, if we are considering a restatement of prior-period financial statements, we consult. See activity 'Consult with the appropriate parties in certain circumstances' for further information on consultation requirements.

1.5.1 US GAAP | Evaluate prior-period uncorrected misstatements detected in prior periods [ISA | 4451]

What do we do?

Evaluate the effect of prior-period uncorrected misstatements that were detected in prior periods in the current-period evaluation of uncorrected misstatements.

Why do we do this?

We evaluate the effect of the prior-period uncorrected misstatements in the current-period evaluation of the uncorrected misstatements because those prior-period misstatements may affect our conclusion about whether the current-period financial statements are materially misstated.

Execute the Audit

How do we quantify and evaluate prior-period uncorrected misstatements to determine whether they are material to the current-period financial statements? [ISA | 4451.1300]

We quantify and evaluate prior-period uncorrected misstatements to determine whether they are material to the current-period financial statements by performing activities:

- 'Accumulate misstatements that are not clearly trivial in the SAM'
- 'Determine the method to quantify and evaluate uncorrected misstatements'. As indicated in this activity, we quantify the misstatements under the appropriate method and evaluate whether the effect of prior-period uncorrected misstatements, individually or in combination with other misstatements that originated in the current period, is material considering both quantitative and qualitative factors. In this evaluation, we consider the misstatements in relation to:
  - the final materiality level(s) used in planning and performing the audit - i.e. final materiality level for the financial statements as a whole and any final lower materiality level for particular accounts or disclosures;
  - the specific financial statement captions and disclosures involved; and
  - the financial statements as a whole - i.e. subtotals and totals in all primary financial statements. With respect to the statement of cash flows, we evaluate the misstatements in relation to operating, investing and financing activities.

How does management generally correct prior-period misstatements? [ISA | 4451.1500]

Management generally corrects prior-period misstatements in the current period unless doing so materially misstates the current-period financial statements. If correcting prior-period misstatements in the current period creates a material misstatement to the current-period financial statements, the entity performs an adjustment in the prior-period financial statements, even though the prior-period misstatements are not material to the prior period's financial statements (i.e. an immaterial correction of an error in the prior-period financial statements).

Example C: New misstatement generated in the income statement under the dual method as a result of an out-of-period correction

Fact pattern

The entity is being provided a regular service for which it will pay $120 at the end of the 6-year contract. Management decided not to record the liability because they do not consider it material. Therefore, at the end of Period 5, the financial statements contain an understated liability of $100 that has built up over 5 years ($20 per period).

Period 1	Period 2	Period 3	Period 4	Period 5	Period 6	Total
$20	$20	$20	$20	$20	$20	$120

In our prior audits, we evaluated the misstatement using the dual method and determined the effect was not material to each of the prior period's financial statements (i.e. Periods 1 - 4).

To evaluate the effect of the misstatement in the current period (i.e. Period 5), we quantify the misstatement using the dual method (both the rollover method and the iron curtain method) and include the misstatement in the current-period SAM:

Method	Quantification of the misstatement
Iron curtain method	Income statement effect (expenses): $100 (debit) Balance sheet effect (liability): $100 (credit)
Rollover method	Income statement effect (expenses): $20 (debit) Balance sheet effect (liability): $100 (credit) Balance sheet effect (retained earnings) $80 (debit) For simplification purposes, this example only includes the balance sheet and income statement effect. However, we also consider any other effect of the misstatement in the other primary financial statements and disclosures.

We evaluate whether the effect of the prior-period uncorrected misstatement, individually or in combination with other misstatements, is material considering both quantitative and qualitative factors. In this evaluation, we consider the misstatements in relation to:

- the final materiality level(s) used in planning and performing the audit - i.e. final materiality level for the financial statements as a whole and any final lower materiality level for particular accounts or disclosures;
- the specific financial statement captions and disclosures involved; and
- the financial statements as a whole - i.e. subtotals and totals in all primary financial statements. With respect to the statement of cash flows, we evaluate the misstatements in relation to operating, investing and financing activities.

As a result, management decides to record the liability.

Analysis

Management intends to record the $100 liability in the current period. As a result of management's correction, $80 will be recorded in the income statement 'out of period' (i.e. management will record an additional $80 of expense in the current period that belongs in prior periods).

As a consequence:

- under the iron curtain method, there is no longer a $100 uncorrected misstatement because the full amount will be recorded as of the end of the period, and
- under the rollover method, there is now an $80 uncorrected misstatement because of the 'out-of-period' expense that will be recorded in the current period.

Method	Quantification of the new misstatement
Iron curtain method	No misstatement.
Rollover method	Income statement effect (expenses): $80 (credit) Balance sheet effect (liability): $0 Balance sheet effect (retained earnings) $80 (debit) For simplification purposes, this example only includes the balance sheet and income statement effect. However, we also consider any other effect of the misstatement in the other primary financial statements and disclosures.

Thus, we include the effect of this new $80 misstatement under the rollover method in an updated SAM.

If the new $80 misstatement is not material to the current-period financial statements, management can record the $100 liability in the current-period financial statements.

If the new $80 misstatement is material to the current-period financial statements, management has to perform an immaterial correction of an error in the prior periods' financial statements the next time the financial statements are issued.

Is the current-period evaluation of the effect of prior-period uncorrected misstatements in an interim review different from the evaluation in an audit? [ISA | 4451.14431]

Yes, but not significantly. The current-period evaluation of the effect of prior-period misstatements in an interim review is as follows:

Prior-period misstatements that originated in:	What do we do?
a prior interim period of the current fiscal period	The information in this activity applies, except for the fact that these prior-period misstatements are assessed against current interim-period financial information and the effect on the trend of earnings.
a prior fiscal period	The information in this activity applies, except for the fact that these prior-period misstatements are assessed against the estimated income for the full current fiscal period and the effect on the trend of earnings. FASB ASC paragraph 250-10-45-27 indicates that the determination of materiality for purposes of reporting the correction of a misstatement in an interim period is based on estimated income for the full fiscal year and the effect on the trend of earnings. KPMG believes that this application of FASB ASC paragraph 250-10-45-27 is appropriate when considering the materiality of a prior-year misstatement in a current-year interim period. **What if the effect of an 'out-of-period' correction is material to the financial information of the interim period?** When the effect of an 'out-of-period' correction is material to the interim financial information in which the correction will be made, but it is not material to the estimated income for the full fiscal period and the effect on trend of earnings, the correction may be made in the interim period. See activity 'Assess error corrections in accordance with FASB 250-10-45-27' for further interim review procedures performed to assess prior-period error corrections in an interim review.

Example D: Evaluation of prior-period misstatements in an interim review
Fact pattern The entity is being provided a regular service for which it will pay $120 at the end of the 6-year contract. Management has not been recording the liability and the expense. Therefore, at the end of Period 4, the financial statements contain an understated liability of $80 that has built up over 4 years ($20 per period).

Period 1	**Period 2**	**Period 3**	**Period 4**	**Period 5**	**Period 6**	**Total**
$20	$20	$20	$20	$20	$20	$120

In our prior audits, we evaluated the misstatement using the dual method and determined the effect was not material to each of the prior period's financial statements (i.e. Periods 1 - 4).

We are performing the review of the first interim-period of fiscal Period 5.

Analysis

We evaluate the effect of the misstatement on the interim-period financial information by:

- accumulating, in the interim-period Summary of Review Misstatements (SRM), the misstatement with other misstatements that affect the interim period.
- quantifying and evaluating the misstatements using the **dual method** (both the rollover method and the iron curtain method):

Method	Quantification of the misstatement
Iron curtain method	Income statement effect (expenses): $85 (debit) Balance sheet effect (liability): $85 (credit)
Rollover method	Income statement effect (expenses): $5 (debit) Balance sheet effect (liability): $85 (credit) Balance sheet effect (retained earnings) $80 (debit) For simplification purposes, this example only includes the balance sheet and income statement effect. However, we also consider any other effect of the misstatement in the other primary financial statements and disclosures within the interim financial information.

We quantify the misstatements and evaluate whether they are material, individually or in combination with other misstatements, considering both quantitative and qualitative factors. In this evaluation, we consider the misstatements in relation to:

- the final materiality level used in planning and performing the review - i.e. final materiality level for the interim financial information as a whole;
- the specific financial statement captions and disclosures involved; and
- the interim financial information as a whole - i.e. subtotals and totals in all primary financial statements. With respect to the statement of cash flows, the engagement team evaluates the misstatements in relation to operating, investing and financing activities.

However, the prior-period misstatement that originated in prior fiscal periods is assessed against the estimated income for the full current fiscal period and the effect on the trend of earnings. Note that $80 of the quantifications above relate to the prior-period misstatement and $5 is the current-period misstatement.

This is a condensed summary of our evaluation of the prior-period misstatement in the first interim period of fiscal Period 5 (income for the first interim period of fiscal Period 5 is $250 and estimated income for the full fiscal Period 5 is $1,000):

	Income statement error (rollover method)	**Income statement error (iron curtain method)**	**Balance sheet error**
	$0	$80	$80
Effect considering income for the first interim period ($250)	N/A	32%	
Effect considering estimated income for the full fiscal Period 5 ($1000)	N/A	**8%**	

We determine that the prior-period misstatement is material to the estimated income for the full fiscal Period 5 (8%) - recording an out-of-period correction in the current period would create a material misstatement in the income statement. Therefore, the entity will perform an immaterial correction of an error in the prior periods' financial statements the next time they are issued, even though the prior-period misstatement is not material to the prior periods' financial statements.

If the prior-period misstatement were not material to the estimated income for the full fiscal Period 5 and to the trend of earnings, the entity could perform an 'out-of-period' correction in the first interim-period's financial information, even though the effect of the 'out-of-period' correction is material to the interim financial information (32%).

Do we consult when the entity is performing an immaterial correction of an error in prior-period financial statements? [ISA | 4451.14495]

Not always. When the entity is performing an immaterial correction of an error in prior-period financial statements, we consult in accordance with activity 'Consult regarding immaterial corrections of errors if applicable'.

Example

How does the engagement team evaluate prior-period uncorrected misstatements in the current period under the dual method? [ISA | 4451.1600]

Fact pattern

In the audit of entity GHI's financial statements, the engagement team identifies two misstatements related to sales cut-off in Period 2:

- $110 of revenue recorded in the current period (Period 2) that should be recorded in the following period (Period 3).
- $50 of revenue that was recorded in the prior period (Period 1) that should have been recorded in the current period (Period 2).

  This is an uncorrected misstatement that the engagement team identified in the audit of Period 1 and determined to be not material to Period 1's financial statements. The entity received the corresponding payment during the current period (i.e. the prior period misstatement reversed in Period 2).

As a result of these misstatements, revenues in the current period are overstated by $60 ($50 understatement partially offset by a $110 overstatement).

Analysis

Quantification and evaluation of the misstatements in Period 2

The engagement team quantifies and evaluates the effect of the uncorrected misstatements on the current-period financial statements by:

- accumulating the misstatements in the current period SAM.
- quantifying and evaluating the misstatements using the dual method (both the rollover method and the iron curtain method):

Method	Quantification of the misstatements
Iron curtain method	Income statement effect (revenue): $110 (debit) Balance sheet effect (accounts receivable): $110 (credit) • $110 is the revenue recorded in Period 2 that should be recorded in Period 3. • The revenue recorded in Period 1 that should have been recorded in Period 2 ($50) does not have an effect under the iron curtain method because the error reversed when the entity received the payment in Period 2.
Rollover method	Income statement effect (revenue): $50 (credit) Balance sheet effect (retained earnings) $50 (debit) Income statement effect (revenue): $110 (debit) Balance sheet effect (accounts receivable): $110 (credit) • $110 is the revenue recorded in Period 2 that should be recorded in Period 3. • $50 is the revenue recorded in Period 1 that should have been recorded in Period 2.

	For simplification purposes, this example only includes the balance sheet and income statement effect. However, we also consider any other effect of the misstatement in the other primary financial statements and disclosures.

The engagement team quantifies the misstatements and evaluates whether the misstatements, individually or in combination with other misstatements, are material considering both quantitative and qualitative factors. In this evaluation, the engagement team considers the misstatements in relation to:

- the final materiality level(s) used in planning and performing the audit - i.e. final materiality level for the financial statements as a whole and any final lower materiality level for particular accounts or disclosures;
- the specific financial statement captions and disclosures involved; and
- the financial statements as a whole - i.e. subtotals and totals in all primary financial statements. With respect to the statement of cash flows, the engagement team evaluates the misstatements in relation to operating, investing and financing activities.

Results of the evaluation of uncorrected misstatements and subsequent management's reactions

After performing its evaluation, the engagement team determines that the misstatements are material to the Period 2 financial statements. Consequently, the entity decides to correct the misstatements.

Taking into consideration the fact that there is one current-period misstatement ($110) and one prior-period misstatement that reversed in the current period ($50), management records:

- $110 in the Period 2 financial statements
- $50 as an immaterial correction of the Period 1 financial statements.

Even though the engagement team determined the $50 misstatement to be immaterial in Period 1, the Period 1 financial statements have to be corrected since its effect is material in Period 2. However, it is not required for the engagement team to amend the previously issued report when the entity corrects immaterial misstatements (like they do in a restatement). The correction may be made the next time the entity issues financial statements that contain the Period 1 financial statements.

1.5.2 US GAAP | Evaluate misstatements detected in the current period that relate to prior periods [ISA | 4453]

What do we do?

Evaluate the effect of misstatements detected in the current period that relate to prior periods.

Why do we do this?

We evaluate the effect of misstatements detected in the current period that relate to prior periods because if they are material to the prior-period financial statements, the entity may have to restate the prior-period financial statements, which would affect our previously issued auditor's report. If a restatement is not necessary, these misstatements may affect our conclusion about whether the current-period financial statements are materially misstated.

Execute the Audit

What do we do when we identify prior-period uncorrected misstatements in the current period? [ISA | 4453.1300]

When we identify prior-period uncorrected misstatements in the current period (i.e. they were previously unknown), we determine whether they are material with respect to the prior-period financial statements (or to the prior interim financial information, if the misstatements originated in a prior interim period of the current fiscal period).

To do this, we update our prior-period evaluation of uncorrected misstatements as follows:

Steps	What do we do?
1	We accumulate the newly identified misstatements that are not clearly trivial with other misstatements that had remained uncorrected in the prior period. See activity 'Accumulate misstatements that are not clearly trivial in the SAM' for information on what clearly trivial means. If we use the rollover method or the dual method to evaluate uncorrected misstatements in our audit engagement, we quantify and evaluate the misstatements using the **rollover method**. See activity 'Determine the method to quantify and evaluate uncorrected misstatements' for information on the **rollover method**. As indicated in that activity, we quantify the misstatements and evaluate whether the effect of the newly identified prior-period uncorrected misstatements, individually or in combination with other misstatements that had remained uncorrected in the prior period, is material to the prior-period financial statements, considering both quantitative and qualitative factors. In this evaluation, we consider the misstatements in relation to: • the prior-period final materiality level(s) used in planning and performing the audit - i.e. final materiality level for the financial statements as a whole and any final lower materiality level for particular accounts or disclosures; • the prior-period specific financial statement captions and disclosures involved; and • the prior-period financial statements as a whole - i.e. subtotals and totals in all primary financial statements. With respect to the statement of cash flows, we evaluate the misstatements in relation to operating, investing and financing activities. One way of doing this is accumulating the misstatements in an updated SAM (or SRM, if the newly identified misstatements originated in a prior interim period of the current fiscal period) using the **rollover method** spreadsheet. This will enable us to properly evaluate the effect of the prior-period uncorrected misstatements on the prior-period financial statements.

2	We follow the relevant procedures for when we have a subsequent discovery of facts. See chapter on subsequent events (AU-C 560, ISA 560) for information on these procedures. As indicated in those chapters, if we are considering a restatement of prior-period financial statements, we consult. See activity 'Consult with the appropriate parties, if necessary' for further information on consultation requirements.
3	When it is necessary to restate previously issued financial statements for reasons other than due to the adoption of new accounting pronouncements, a change in accounting principle or the application of an accounting principle that requires or permits retroactive application, we perform an EQC review on the restated financial statements and/or financial information.

Why do we use only the rollover method to determine whether the prior-period financial statements are materially misstated, even if we use the dual method in our audit engagement? [ISA | 4453.14436]

We use only the rollover method to determine whether the prior-period financial statements are materially misstated, even if we use the dual method in our audit engagement, because it is the method that quantifies the 'actual' misstatement in each period affected.

We focus on the differences between the '**as reported'** balances versus the '**as corrected'** balances. The 'as corrected' balances are the balances that would have been reported, had the entity recorded the right amounts in each of the prior periods affected.

What happens if the effect of the newly identified prior-period misstatements is material to the prior-period financial statements (or to the prior interim financial information, if the misstatements originated in a prior interim period of the current fiscal period)? [ISA | 4453.14440]

If the effect of the newly identified prior-period misstatements is material to the prior-period financial statements (or to the prior interim financial information, if the misstatements originated in a prior interim period of the current fiscal period), the entity restates the prior-period financial statements (or the prior interim financial information).

If the entity restates the prior-period financial statements (or the prior interim financial information), the current-period SAM (or SRM) does not include the prior-period misstatements identified in the current period anymore as they have been corrected in the proper period.

What happens if the effect of the newly identified prior-period misstatements is not material to the prior-period financial statements (or to the prior interim financial information, if the misstatements originated in a prior interim period of the current fiscal period)? [ISA | 4453.14441]

If the effect of the newly identified prior-period misstatements is not material to the prior-period financial statements (or to the prior interim financial information, if the misstatements originated in a prior interim period of the current fiscal period), we perform activity 'Evaluate prior-period uncorrected misstatements detected in prior periods' to further evaluate the effect of the prior-period misstatements on the current-period financial statements.

What do we do when we identify prior-period uncorrected misstatements in the current period and we were not the auditors in the prior period? [ISA | 4453.1500]

When we identify prior-period uncorrected misstatements in the current period (i.e. they were not previously known) and we were not the auditors in the prior period, we perform the activity 'Perform additional procedures when a possible misstatement is identified'.

Example

How does the engagement team evaluate prior-period uncorrected misstatements detected in the current period when we use the dual method in the audit engagement? [ISA | 4453.1600]

Fact pattern

The entity is being provided a regular service for which it will pay $120 at the end of the 6-year contract. Management has not been recording the liability. Therefore, at the end of Period 4, the financial statements contain an understated liability of $80 that has built up over 4 years ($20 per period).

Period 1	Period 2	Period 3	Period 4	Period 5	Period 6	Total
$20	$20	$20	$20	$20	$20	$120

The misstatement was not identified until the first interim period of the current fiscal period (i.e. first interim period of fiscal Period 5).

Analysis

The engagement team updates the prior-period evaluations of uncorrected misstatements (i.e. Period 1 - 4) by:

- accumulating the newly identified misstatement with other misstatements that had remained uncorrected in the prior periods.
- quantifying and evaluating the misstatements using the **rollover method** (on an '**as reported' versus 'as corrected**' basis).

Method	Effect in the financial statements	Period 1	Period 2	Period 3	Period 4
Rollover method	Income statement effect	$20	$20	$20	$20
	Balance sheet effect	$20	$40	$60	$80

For simplification purposes, this example only includes the balance sheet and income statement effect. However, the engagement team also considers any other effect of the misstatement in the other primary financial statements and disclosures.

The engagement team quantifies the misstatements and evaluates whether the effect of the newly identified prior-period uncorrected misstatement, individually or in combination with other misstatements that had remained uncorrected in the prior periods, is material to the prior-periods' financial statements, considering both quantitative and qualitative factors. In these evaluations, the engagement team considers the misstatements in relation to:

- the prior-periods' final materiality level(s) used in planning and performing the audit - i.e. final materiality level for the financial statements as a whole and any final lower materiality level for particular accounts or disclosures;
- the prior-periods' specific financial statement captions and disclosures involved; and
- the prior-periods' financial statements as a whole - i.e. subtotals and totals in all primary financial statements. With respect to the statement of cash flows, the engagement team evaluates the misstatements in relation to operating, investing and financing activities.

This is a condensed summary of the engagement team's evaluations (reported income for all the periods affected was $1,000):

Period	Reported income	Income statement error	Balance sheet error
1	$1,000	$20 (2%)	$20
2	$1,000	$20 (2%)	$40
3	$1,000	$20 (2%)	$60
4	$1,000	$20 (2%)	$80

The engagement team determines that **none** of the prior-period financial statements affected by the newly identified misstatement are materially misstated.

If the newly identified misstatement were **material to any** of the prior-period financial statements (i.e. Period 1 - 4), the entity would restate the previously issued financial statements affected by the misstatement and the engagement team would amend their corresponding auditor's reports.

As **none** of the prior-period financial statements affected by the newly identified misstatement are materially misstated, the engagement team further evaluates the effect of the misstatement on the current-interim financial information by:

- accumulating, in the interim-period Summary of Review Misstatements (SRM), the newly identified misstatement with other misstatements that affect the interim period.
- quantifying and evaluating the misstatements using the **dual method** (both the rollover method and the iron curtain method):

Method	Quantification of the misstatement
Iron curtain method	Income statement effect (expenses): $85 (debit) Balance sheet effect (liability): $85 (credit)
Rollover method	Income statement effect (expenses): $5 (debit) Balance sheet effect (liability): $85 (credit) Balance sheet effect (retained earnings) $80 (debit) For simplification purposes, this example only includes the balance sheet and income statement effect. However, the engagement team also considers any other effect of the misstatement in the other primary financial statements and disclosures within the interim financial information.

The engagement team quantifies the misstatements and evaluates whether they are material, individually or in combination with other misstatements, considering both quantitative and qualitative factors. In this evaluation, the engagement team considers the misstatements in relation to:

- the final materiality level used in planning and performing the review - i.e. final materiality level for the interim financial information as a whole;
- the specific financial statement captions and disclosures involved; and
- the interim financial information as a whole - i.e. subtotals and totals in all primary financial statements. With respect to the statement of cash flows, the engagement team evaluates the misstatements in relation to operating, investing and financing activities.

However, the prior-period misstatement that originated in prior fiscal periods is assessed against the estimated income for the full current fiscal period and the effect on the trend of earnings. Note that $80 of the quantifications above relate to the prior-period misstatement and $5 is the current-period misstatement.

This is a condensed summary of the engagement team's evaluation of the prior-period misstatement in the first interim period of fiscal Period 5 (income for the first interim period of fiscal Period 5 is $250 and estimated income for the full fiscal Period 5 is $1,000):

	Income statement error (rollover method)	Income statement error (iron curtain method)	Balance sheet error

	$0	$80	$80
Effect considering income for the first interim period ($250)	N/A	32%	
Effect considering estimated income for the full fiscal Period 5 ($1000)	N/A	**8%**	

The engagement team determines that the newly identified misstatement is material to the estimated income for the full fiscal Period 5 (8%) - recording an out-of-period correction in the current period would create a material misstatement in the income statement. Therefore, the entity will perform an immaterial correction of an error in the prior periods' financial statements the next time they are issued, even though the prior-period misstatement is not material to the prior periods' financial statements.

If the newly identified misstatement were not material to the estimated income for the full fiscal Period 5 and to the trend of earnings, the entity could perform an 'out-of-period' correction in the first interim-period's financial information, even though the effect of the 'out-of-period' correction is material to the interim financial information (32%).

1.5.3 US GAAP | Consult regarding immaterial corrections of errors if applicable [ISA | 4148]

What do we do?

IF the entity intends to perform an immaterial correction of an error in previously issued financial statements audited or reviewed by us, THEN consult appropriately if applicable.

Why do we do this?

In accordance with US GAAP, a material correction of an error in prior-period financial statements requires a restatement (i.e. an amendment of previously issued financial statements and re-issuance of the auditors' or review report). However, an immaterial correction does not result in a restatement. Given the ramifications of incorrectly assessing the correction, we consult appropriately.

Execute the Audit

In what circumstances and with whom do we consult if the entity intends to perform an immaterial correction of an error in previously issued financial statements? [ISA | 4148.1300]

If the entity intends to perform an immaterial correction of an error in previously issued financial statements audited or reviewed by us, we consult with DPP UNLESS:

we have concluded that there are no qualitative factors that indicate the correction is material (e.g. involves fraud or impacts compensation, including triggering a clawback policy) AND EITHER:

a) the correction is less than the materiality used in performing the audit of those previously issued financial statements, and corrected and uncorrected misstatements do not exceed materiality individually or in the aggregate; OR

b) the correction relates to a presentation or disclosure error that does not affect revenue or other key metrics (e.g. gross margin for a manufacturer), including key non-GAAP metrics (e.g. those relevant to determining materiality or a clawback policy), and is less than 5x materiality individually or in the aggregate.

See activity 'Evaluate uncorrected misstatements taking into account quantitative and qualitative factors' in this chapter for information about how we consider qualitative factors when evaluating uncorrected misstatements.

What if the previously issued financial statements were audited in accordance with the PCAOB standards? [ISA | 4148.8851]

If the previously issued financial statements were audited in accordance with the PCAOB standards, we consult in accordance with KAEG-P activity 'Consult regarding immaterial corrections of errors if applicable' in chapter AS 2810.

What information may we provide to DPP? [ISA | 4148.14911]

When we consult because the entity intends to perform an immaterial correction of an error, we may provide the following information to DPP to help in the consultation, especially if the error was identified in the current period:

- description of the error and how it was identified;
- qualitative and quantitative factors considered in concluding that the error is immaterial, individually and in the aggregate;
- nature of and reason for the error, including whether the error was the result of fraud and/or a control deficiency;
- description of how management has addressed (or is addressing) the primary cause(s) of the error;
- if applicable, identification of deficiencies in internal control that failed to prevent, or detect and correct the error, the severity of the deficiencies and whether they have been communicated to management and those charged with governance;
- if applicable, the impact of any identified internal control deficiency on our previously issued auditors' report on ICFR;
- if applicable, the impact of any identified internal control deficiency on management's ICFR evaluation and officer's certifications;
- consideration of whether it is necessary to modify the original risk assessments.

What do we do if we disagree with management about the materiality of the corrected error in previously issued financial statements? [ISA | 4148.14913]

When the misstatement is identified in the current period, if management believes that the corrected misstatement is immaterial, but we believe it to be material, then we consider the previously issued financial statements to be materially misstated. In such cases, we take action to prevent future reliance on our auditor's report, if necessary (see activity 'Take action to prevent future reliance on our auditor's report, if necessary').

Communication with Those Charged with Governance

International Standards on Auditing: ISA 450.12-13

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.[4] The auditor's communication shall identify material uncorrected misstatements individually. The auditor shall request that uncorrected misstatements be corrected. (Ref: Para. A26 - A28)

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4 See footnote 3.

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.

ISA Application and Other Explanatory Material: ISA 450.A26-A28

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

A26. 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.[17]

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17 ISA 260 (Revised), paragraph 13

A27. 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.

A28. ISA 260 (Revised) requires the auditor to communicate with those charged with governance the written representations the auditor is requesting (see paragraph 14 of this ISA).[18] 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.

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18 ISA 260 (Revised), paragraph 16(c)(ii)

How do we comply with the Standards? [ISA | KAEGHDWC]

1 Communicate uncorrected misstatements [ISA | 1252]

What do we do?

Communicate uncorrected misstatements and related matters to those charged with governance.

Why do we do this?

Communicating to those charged with governance misstatements helps them to exercise their oversight responsibilities.

Execute the Audit

What do we communicate to those charged with governance regarding misstatements? [ISA | 1252.1300]

We communicate with those charged with governance:

- uncorrected misstatements, unless prohibited by law or regulation. If there are uncorrected misstatements that are material, our communication identifies those misstatements individually. We also communicate the effect that the uncorrected misstatements, individually or in aggregate, may have on the opinion in the auditor's report.

  In addition, we request those charged with governance that uncorrected misstatements be corrected.
- 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.

Can we combine misstatements when we communicate with those charged with governance? [ISA | 1252.1500]

It depends. When there is a large number of individual immaterial uncorrected misstatements, we may communicate the number and overall monetary effect of the uncorrected misstatements, rather than the details of each individual uncorrected misstatement.

When do we communicate misstatements to those charged with governance? [ISA | 1252.1600]

We usually communicate misstatements after completion of the test work on the financial statements. However, sometimes, we may consider it necessary to communicate certain misstatements as soon as possible after we identify them.

What is the form of our communication to those charged with governance regarding misstatements? [ISA | 1252.1700]

We communicate to those charged with governance either orally or in writing.

In relation to the communication of misstatements, we may consider that the communication is more appropriate in writing. We may provide to those charged with governance the "Summary of Audit Misstatements - uncorrected" or any other schedule that has the complete population of uncorrected misstatements. This schedule could be the same as the one included in the management representation letter.

Even if we communicate in writing, having a dialogue with those charged with governance is a key factor in effective two-way communications. Therefore, written communications usually lead to an active two-way discussion with those charged with governance.

What do we do when law or regulation prohibits communicating misstatements? [ISA | 1252.1800]

When law or regulation restricts our communication of certain misstatements to management and/or those charged with governance, the engagement partner consults with the risk management partner.

In some jurisdictions, law or regulation may restrict our communication to management and/or those charged with governance - or other related action - of certain misstatements to avoid harming an investigation into an illegal act by an appropriate authority.

> For example, laws or regulations may specifically prohibit alerting the entity when we are required to report to an appropriate authority in accordance with anti-money laundering legislation.

What may we communicate regarding misstatements in addition to the required communications? [ISA | 1252.1900]

In addition to the required communications regarding misstatements, we may also:

- discuss with those charged with governance the reasons for, and the implications of, a failure to correct misstatements, and possible implications in relation to future financial statements.
- provide those charged with governance with the "Summary of Audit Misstatements - corrected section" or any other schedule that has the complete population of corrected misstatements.

Written Representations

International Standards on Auditing: ISA 450.14

Written Representations

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. A29)

ISA Application and Other Explanatory Material: ISA 450.A29

Written Representations (Ref: Para. 14)

A29. 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.

How do we comply with the Standards? [ISA | KAEGHDWC]

1 Obtain written representations for all financial statement periods [ISA | 3851]

What do we do?

Obtain written representations from management for all financial statement periods covered by the auditor's report

Why do we do this?

While management representations do not provide sufficient appropriate audit evidence on their own, they complement the evidence we obtain from other auditing procedures. Specifically, they serve as a written record of management's acknowledgement that they have fulfilled their responsibilities, their understanding and evaluation of audit differences and their honesty and cooperation with us during the audit. Accordingly, failure of management to provide written representations requested by the auditor can have serious implications on the audit and on our report.

Execute the Audit

Which financial statement period(s) do management's written representations relate to? [ISA | 3851.1300]

The written representations relate to all financial statement periods covered in the audit report, including prior periods that are presented in the financial statements.

Why do we obtain management's written representations about prior periods that have already been reported?

Management reaffirms to us that the written representations from previous period(s) remain appropriate before we sign our audit opinion in the current year, as our audit opinion relates to all periods presented in the financial statements. If a restatement has been made to correct a material misstatement in the prior period that affects the comparative financial statements, then we draft a specific representation for management to review and also reaffirm.

What written representations do we obtain from management if we are issuing more than one audit report?

We obtain representations from management for all audit reports issued, either in one representation letter, listing the applicable set of financial statements, or in separate representation letters for each set of financial statements.

Who prepares the management representation letter? [ISA | 3851.1600]

We prepare the MRL template and provide it to management for their review and signature.

How do we prepare the management representation letter? [ISA | 3851.15774]

We first select the appropriate KPMG example MLR template https://alex.kpmg.com/AROWeb/document/lfc/GSC_INTL_AUDDOC_DOCSEAUDIT_TOC/toc/GSC_INTL_AUDDOC_DOCSEAUDIT_TOC?tocref=GSC_INTL_AUDDOC_DOCSEAUDIT_TOC, depending on the applicable auditing standards, financial reporting framework used by the entity and legal and regulatory framework in which the entity operates.

We then determine any additional representations to include in the MLR template. Attachment 1 provides additional representations that we may include, depending on the other circumstances that are applicable to the entity. At a minimum, we include all required representations from the auditing standards, which are included in the KPMG example MLR template.

In some circumstances, we use nationally-tailored versions of the base representation letter and/or listing of additional representations.

Once we have compiled all applicable representations into the MRL template, we provide it to management.

How do we determine which additional representations, beyond those which are required, are appropriate in the circumstances of our audit? [ISA | 3851.1800]

We select additional representations based on the specific facts and circumstances of the audit and the entity we audit. This can include additional representations to address a variety of topics, such as:

- specific circumstances related to the engagement and basis of presentation of the financial statements (e.g. US GAAP, IFRS);
- specific types of transactions, balances and disclosures present at the entity;
- the nonexistence of transactions/balances/disclosures or circumstances that commonly exist for entities or entities within a particular industry;
- management's intent (e.g., intention to reinvest undistributed earnings of a foreign subsidiary) or plans (e.g., going concern);
- oral representations made to us by management, explicitly or implicitly, during the course of our audit (e.g., disclosure of unique sales terms);
- information presented with the audited financial statements that is not contemplated by the base letter (e.g., supplemental information, adjustments to a prior period that are audited by us as the successor auditor);
- specialized circumstances or disclosures (e.g., restatement, restructuring); and
- management's selection and application of accounting policies, for example non-GAAP policies.

When might it be appropriate for management to modify the representations we have requested from them? [ISA | 3851.2100]

We expect that management will not make any major revisions to the letter template we provide. We review the signed letter that is provided back to us to allow us to make sure we agree with final version, including any revisions management may have made or proposed.

In some cases, management may modify a representation to further describe and represent relevant facts and circumstances, but not to change or limit its meaning or contradict the auditing standards.

Base representations (i.e. required representations), are not to be removed or modified by management unless it adds an "except for" clause to highlight a matter already disclosed in the financial statements and/or disclosed to the auditor. If management modifies the base representations, refer to activity 'Consider the effect if management refuses to provide representations ' to determine what to do.

Examples of representations modified by management:

	Default Language:	Example Modified Language:
Scenario 1 : *An event subsequent to the balance sheet has been disclosed in financial statements*	To the best of our knowledge and belief, no events have occurred subsequent to the balance-sheet date and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.	To the best of our knowledge and belief, except as discussed in Note X to the financial statements, no events have occurred subsequent to the balance-sheet date and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.
Scenario 2: *Management plans to dispose of a specific business segment*	The company has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.	The company has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities, except for its plans to dispose of segment A, as disclosed in Note X to the financial statements, which are discussed in the minutes of the December 7, 20X1 meeting of the board of directors.
Scenario 3: *Management has received a communication of an allegation of fraud or suspected fraud*	We have no knowledge of any allegations of fraud or suspected fraud affecting the entity received in communications from employees, analysts, regulators, short sellers, or others.	Except for the allegation discussed in the minutes of the December 7, 20X1 meeting of the board of directors (or disclosed to you at our meeting on October 15, 20X1), we have no knowledge of any allegations of fraud or suspected fraud affecting the company received in communications from

		employees, former employees, analysts, regulators, short sellers, or others.

If we think management may have questions as to the meaning of certain terminology used in the MRL template, we may consider providing those definitions to management or requesting that they include the definitions in the MRL response to confirm their understanding.

How does the management representation letter address materiality? [ISA | 3851.2200]

Management representations may be limited to matters that are considered individually or in the aggregate to be material to the financial statements. In order for management to exclude "immaterial" items from its representations, we first come to a common understanding with management as to what is material. Materiality may be different for different representations, similar to the concept of having different materiality considerations for specific areas of the audit.

A discussion of materiality may be included explicitly in the representation letter, in either qualitative or quantitative terms.

Does the concept of materiality apply to all management representations?

No. Materiality does not apply to:

- representations not directly related to financial statement amounts;
- any representations regarding the possible effects of fraud on other aspects of the audit; or
- items that involve an omission or misstatement of accounting information that, based on the circumstance, would change or influence the judgment of a reasonable person relying on the financial statements if the omission or misstatement were adjusted.

The following table sets out some examples of representations in which materiality would not be applicable.

	Representation
Example 1	We confirm that we are responsible for the fair presentation in the [consolidated] financial statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles [or other applicable accounting framework].
Example 2	We have made available to you all - (a) Financial records and related data, including the names of all related parties and all relationships and transactions with related parties. (b) Minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.

Example 3	There have been no communications from regulatory agencies concerning non-compliance with or deficiencies in financial reporting practices.
Example 4	We acknowledge our responsibility for the design and implementation of programs and controls to prevent and detect fraud.

Do we attach any information to the management representation letter? [ISA | 3851.15776]

Yes. We attach a summary of uncorrected misstatements, which includes the nature, amount, and effect of the uncorrected misstatements, excluding those misstatements that are clearly trivial. We also include a listing of omissions of amounts or disclosures in the financial statements.

We use the KPMG template, Summary of Audit Misstatements (SAM) - uncorrected misstatements section for the summary of uncorrected misstatements unless law, regulation or custom specifies a different format.

While not required, we also may choose to attach a summary of corrected misstatements.

How is the management representation letter adjusted when management disagrees with an uncorrected misstatement? [ISA | 3851.15778]

If management does not agree with a misstatement we have included on the SAM - uncorrected misstatements section attached to the MRL, they may modify the representation about uncorrected audit misstatements as follows:

We do not agree that items ... and ... constitute misstatements because [description of reasons].

Documentation

International Standards on Auditing: ISA 450.15

Documentation

15. The auditor shall include in the audit documentation:[5] (Ref: Para. A30)

(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).

5 ISA 230, *Audit Documentation* , paragraphs 8-11, and A6

ISA Application and Other Explanatory Material: ISA 450.A30

Documentation (Ref: Para. 15)

A30. 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).

How do we comply with the Standards? [ISA | KAEGHDWC]

1 Accumulate misstatements that are not clearly trivial in the SAM [ISA | 4435]

What do we do?

Accumulate misstatements identified during the audit that are not clearly trivial in the Summary of Audit Misstatements - corrected and uncorrected sections - distinguishing between factual, judgmental and projected misstatements.

Why do we do this?

Although we may identify a number of misstatements during the audit, we may not necessarily accumulate all of them. We do not accumulate clearly trivial misstatements identified in both accounts and disclosures because their accumulation would not have a material effect on the financial statements, individually or in combination with other misstatements.

Execute the Audit

Which misstatements do we accumulate? [ISA | 4435.1300]

We accumulate all misstatements that are not clearly trivial, identified in both accounts and disclosures and that arose in both the current period and prior periods.

Misstatements in disclosures may also be clearly trivial. Even though we cannot 'add up' the misstatements in disclosures numerically, we still accumulate the ones that are not clearly trivial and evaluate their effect collectively with other misstatements identified.

Where do we accumulate the misstatements that are not clearly trivial? [ISA | 4435.1400]

We accumulate the misstatements that are not clearly trivial in the Summary of Audit Misstatements (SAM).

The SAM is a tool that we use to accumulate the misstatements that are not clearly trivial. It has two sections:

- *Uncorrected misstatements* section - to capture those misstatements identified by any party (us - including component auditors -, management or others) that management *did not correct* in the financial statements; and
- *Corrected misstatements* section - to capture those misstatements identified by us - including component auditors - that management *corrected* in the financial statements.

Do we distinguish between factual misstatements, judgmental misstatements and projected misstatements in the SAM? [ISA | 4435.1500]

Yes. To assist us in evaluating the effect of misstatements accumulated during the audit and in communicating misstatements to management and/or those charged with governance, we distinguish between factual misstatements, judgmental misstatements and projected misstatements in the SAM.

What is a factual misstatement, a projected misstatement and a judgmental misstatement? [ISA | 4435.14385]

Type of misstatement	What is it?
Factual misstatement	A factual misstatement is a misstatement about which there is no doubt.
Judgmental misstatement	A judgmental misstatement is our best estimate of the misstatement in an account or disclosure in which judgment is involved. It is a difference arising from the judgments of management concerning accounting estimates or the selection or application of accounting principles.
Projected misstatement	A projected misstatement is our best estimate of the misstatement in populations involving audit sampling. It is the projection of misstatements identified in a sample to the entire population from which the sample items were drawn.

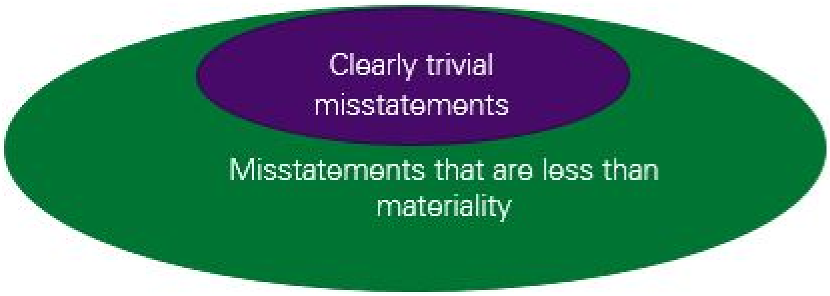
Which are the clearly trivial misstatements that we do not accumulate? [ISA | 4435.1600]

Clearly trivial misstatements are those that are inconsequential, whether taken individually or in the aggregate, and whether judged by any criteria of size, nature or circumstances.

We do not accumulate clearly trivial misstatements identified in both accounts and disclosures because their accumulation would not have a material effect on the financial statements.

Is 'clearly trivial' the same as 'not material'? [ISA | 4435.14420]

No. 'Clearly trivial' is not the same as 'not material'. Clearly trivial misstatements are of a smaller magnitude, or a wholly different nature, than those that are material. We likely consider only a subset of those misstatements that are less than the materiality level(s) clearly trivial, as demonstrated in the diagram below.



Furthermore, the size of a misstatement is not our only consideration to determine whether it is clearly trivial. Its qualitative factors - i.e. the nature and circumstances of the misstatement - may also influence our views on whether a misstatement is "clearly trivial".

How do we determine whether a misstatement is clearly trivial? [ISA | 4435.1700]

We determine whether a misstatement is clearly trivial by taking into account:

- an amount known as the Audit Misstatement Posting Threshold (AMPT). We use the AMPT as a quantitative threshold for determining whether a misstatement is clearly trivial. See activity 'Determine AMPT, lower AMPT and their revisions, if applicable' for further information about how to set AMPT.
- relevant qualitative factors - i.e. nature and circumstances of a misstatement. Performing activity 'Evaluate the nature of and reasons for the misstatements' when the misstatement is identified helps us to determine whether there are qualitative factors that may indicate that the misstatement is not clearly trivial.

> Examples of qualitative matters include:
>
> - a misstatement involving fraud and/or illegal acts;
> - the potential effect of a misstatement on:
>   - the compliance with loan covenants;
>   - management's compensation - i.e. bonuses;
>   - whether earnings per share targets/expectations are met;
> - a misstatement that changes a loss into income or vice versa.
>
> The presence of one or more of these qualitative matters may be an indicator that the misstatement is not clearly trivial.

If a misstatement is above AMPT, it is not clearly trivial and we include it in the SAM.

If a misstatement is below AMPT, we consider it to be clearly trivial, unless there are qualitative factors - i.e. nature and circumstances of a misstatement - that suggest otherwise.

What do we do when there is uncertainty about whether one or more misstatements are clearly trivial? [ISA | 4435.14422]

When there is any uncertainty about whether one or more misstatements are clearly trivial, the matter is not trivial.

Group Audit or Component Audit | Is our approach to determining whether a misstatement is clearly trivial the same in a group audit and in a stand-alone audit? [ISA | 4435.14423]

No, the approach is different because in a group audit, the component auditors may report misstatements that are less than group AMPT to the group auditor, and, depending on the circumstances, the group auditor could consider those misstatements not clearly trivial when aggregated with other similar misstatements.

Group Audit or Component Audit | How do the component auditors determine what misstatements to report to the group auditor? [ISA | 4435.14424]

We, as the component auditors, determine what misstatements to report to the group auditor by taking into account:

- an amount known as the Audit Misstatement Reporting Threshold (AMRT). We use the AMRT as a quantitative threshold for determining what misstatements to report to the group auditor. See activity 'Determine AMRT, lower AMRT and their revisions, if applicable' for further information about how to set AMRT and why.
- relevant qualitative factors - i.e. nature and circumstances of a misstatement. Performing activity 'Evaluate the nature of and reasons for the misstatements' when the misstatement is identified helps us to determine whether there are qualitative factors that may indicate that the misstatement is not clearly trivial for the group.

If a misstatement is above AMRT, we report it to the group auditor.

If a misstatement is below AMRT, we do not report it to the group auditor, unless there are qualitative factors - i.e. nature and circumstances of a misstatement - that merit reporting.

We report uncorrected and corrected misstatements separately.

Group Audit or Component Audit | How does the group auditor determine whether a misstatement is clearly trivial? [ISA | 4435.14425]

We, as the group auditor, consider all misstatements that we are aware of (e.g. identified by us, identified by management, communicated by component auditors) and determine whether they are clearly trivial. We determine whether a misstatement is clearly trivial by taking into account:

- an amount known as the group AMPT. The group auditor uses the group AMPT as a quantitative threshold for determining whether a misstatement (or group of misstatements by account or disclosure across the group) is clearly trivial. See activity 'Determine AMPT, lower AMPT and their revisions, if applicable' for further information about how to set group AMPT.
- relevant qualitative factors - i.e. nature and circumstances of a misstatement. Performing activity 'Evaluate the nature of and reasons for the misstatements' when the misstatement is identified helps us to determine whether there are qualitative factors that may indicate that the misstatement is not clearly trivial.

Examples of qualitative matters include:

- a misstatement involving fraud and/or illegal acts;
- the potential effect of a misstatement on:
    - the compliance with loan covenants;

- management's compensation - i.e. bonuses;
- whether earnings per share targets/expectations are met;

- a misstatement that changes a loss into income or vice versa.

The presence of one or more of these qualitative matters may be an indicator that the misstatement is not clearly trivial.

In this determination, we may follow the following steps:

Steps	What may we do?
Consideration of misstatements in aggregate	We may aggregate misstatements that are of the same type. Misstatements are of the same type when: • the misstatements affect the same accounts • the nature of and reasons for the misstatements are the same. We use judgment if we consider offsetting overstatements and understatements. It may not be appropriate to offset misstatements within the same account balances when: • some or all misstatements are above group AMPT; • those misstatements affect presentation and/or disclosures in the financial statements; • there are both estimated misstatements (projected or judgmental) and more precise (factual) misstatements; and • offsetting is not consistent with the applicable financial reporting framework. If the aggregated amount(s) is above group AMPT, it is not clearly trivial and we include it in the group SAM. If the aggregated amount(s) is below group AMPT, we consider it to be clearly trivial, unless there are qualitative factors - i.e. nature and circumstances of the misstatements - that suggest otherwise. For example, if group AMPT is $100 and there are two uncorrected misstatements in the accounts receivable/revenue accounts that represent overstatements - one for $50 in component A and the other one for $80 in component B - both misstatements are not clearly trivial as the aggregate is $130, which is above group AMPT. We include in the group SAM a misstatement of $130.
Consideration of misstatements individually	We may compare the other misstatements that were not aggregated with group AMPT individually. If a misstatement is above group AMPT, it is not clearly trivial and we include it in the group SAM.

	If the misstatement is below group AMPT, we consider it to be clearly trivial, unless there are qualitative factors - i.e. nature and circumstances of the misstatements - that suggest otherwise.
Consideration of patterns in misstatements	We analyze whether there are any patterns in the misstatements that could indicate an issue across the group. For example, • misstatements in the same accounting estimate across many components that have the same effect in the financial statements - consistent overstatement or consistent understatement - may indicate that there may be management bias and that those misstatements are not clearly trivial. • misstatements in the same account across many components - even if the other side of the entries affect multiple accounts - may indicate that those misstatement are not clearly trivial, depending on the circumstances.

Finally, we consider corrected and uncorrected misstatements separately as these misstatements are included in different sections in the group SAM.

For example, if group AMPT is $100 and there are two misstatements in the accounts receivable/ revenue accounts that represent overstatements in component A - one corrected for $50 and the other one uncorrected for $80 - we do not include them in the group SAM as we do not aggregate corrected misstatements with uncorrected misstatements. We separately assess if the uncorrected misstatement aggregates with other uncorrected misstatements and if it is quantitatively not clearly trivial.

Examples

How does an engagement team determine whether a misstatement is clearly trivial? [ISA | 4435.1800]

Scenario 1 **: Clearly trivial misstatement**

Fact pattern

An engagement team is performing an audit of the financial statements of Entity A, which acquired 10 new fixed assets during the period amounting to $1,000,000 in total. AMPT is $5,000.

One of the planned substantive audit procedures over property, plant, and equipment is to inspect supporting third party invoices for each of the 10 fixed asset additions. In performing the audit procedures, the engagement team discovers a difference of $3,500 between the recorded amount of an asset and the amount given on the supporting invoice. They determine that this is the result of a simple human mistake and is not intentional.

Analysis

As a result, the engagement team concludes that the $3,500 misstatement is clearly trivial because it is below AMPT and there is nothing about the nature of or the reason for the misstatement that suggests it is more than inconsequential.

Scenario 2 **: Misstatement that is not clearly trivial**

Fact pattern

Let us assume the same facts as in Scenario 1. However, this time, the engagement team determines that the difference of $3,500 is the result of the CFO misappropriating assets of the entity.

Analysis

While the misstatement identified is below the AMPT of $5,000, the misstatement is not clearly trivial because it involves fraud by a member of senior management.

As a result, the engagement team accumulates the $3,500 misstatement in the SAM and evaluates the effect on the audit - e.g. considering other implications on the audit like management's integrity and client continuance evaluation.

2 Evaluate whether uncorrected misstatements are material and the implications [ISA | 4443]

What do we do?

Evaluate whether uncorrected misstatements are material and the implications.

Why do we do this?

The existence of material misstatements in the financial statements is one of the reasons that can prevent us from issuing an unqualified opinion. Therefore, if we fail to evaluate whether the uncorrected misstatements are material, we may issue an inappropriate unqualified opinion.

Execute the Audit

What is an uncorrected misstatement? [ISA | 4443.1300]

An uncorrected misstatement is a misstatement that is not clearly trivial - i.e. that we accumulated - and that management has not corrected.

Does our evaluation include all uncorrected misstatements? [ISA | 4443.1400]

Yes. Our evaluation includes all uncorrected misstatements that are not clearly trivial, regardless of:

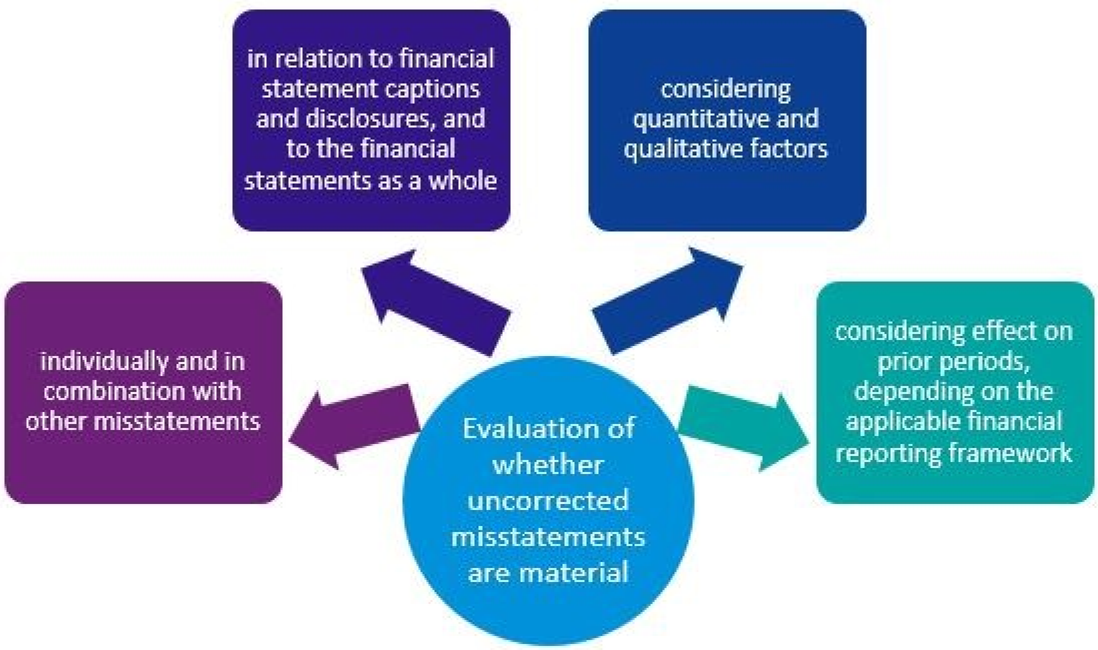
- the nature of the misstatement - e.g. misstatements in amounts or misstatements in narrative disclosures;
- who identified them - e.g. management, component auditors, or us;
- how they were identified - e.g. performing inquiries of management or performing test of details using a sample and extrapolating the error found; or
- whether they arose in the current period or prior periods.

Group Audit | Does the group auditor also evaluate uncorrected misstatements identified by component auditors? [ISA | 4443.14022]

Yes. The group engagement partner evaluates the effect on the group audit opinion of any uncorrected misstatements (whether identified by the group auditor or communicated by component auditors).

How do we evaluate whether the uncorrected misstatements are material? [ISA | 4443.14020]

In our evaluation of whether the uncorrected misstatements are material, we think critically about everything we know about the entity and the factors that we could reasonably expect to influence the economic decisions of users of the financial statements. We perform our evaluation as follows:



Misstatements are considered material if they could reasonably be expected to influence the economic decisions of financial-statement users. Therefore, size is just one of the characteristics of the misstatements we consider. This evaluation is not merely a simple numeric comparison, e.g. adding all misstatements and comparing the result to the materiality level for the financial statements as a whole. On the contrary, there are many facets as described in the graphic above.

What are the methods we use to quantify and evaluate the effect of uncorrected misstatements in the financial statements? [ISA | 4443.1600]

There are three methods auditors use to quantify and evaluate the effect of uncorrected misstatements on the financial statements:

- the Iron Curtain Method, also referred to as the 'balance sheet method';
- the Rollover Method, also referred to as the 'income statement method'; or
- the Dual Method. Under this method, the misstatements are analyzed under both the iron curtain and rollover methods.

In an audit conducted in accordance with the PCAOB standards, we use the dual method.

Group Audit | How does the group auditor evaluate uncorrected misstatements of the group financial statements? [ISA | 4443.1700]

We, as the group auditor, evaluate the uncorrected misstatements in the same way as we evaluate uncorrected misstatements in a stand-alone audit.

The group engagement partner's evaluation includes consideration of whether corrected and uncorrected misstatements communicated by component auditors indicate a systemic issue (e.g., regarding transactions subject to the same accounting policies or controls) that may affect other components.

What do we include in our audit documentation regarding our evaluation of uncorrected misstatements? [ISA | 4443.1800]

We document our conclusion as to whether uncorrected misstatements are material, individually or in combination with other misstatements, and the basis for that conclusion. The basis of the conclusion may cover all the facets of our evaluation mentioned in the graphic above, including when corrected and uncorrected misstatements communicated by component auditors indicate a systemic issue (e.g., regarding transactions subject to the same accounting policies or controls) that may affect other components.

What do we do if there is a material misstatement in the financial statements? [ISA | 4443.1900]

If there are uncorrected misstatements that are material to the financial statements, we express a qualified or adverse opinion, depending on the pervasiveness of the matter. The existence of a material misstatement in the financial statements is one of the reasons that can prevent us from issuing an unqualified opinion.

What activities do we perform to evaluate uncorrected misstatements? [ISA | 4443.14368]

To evaluate uncorrected misstatements, we perform the following activities:

- Confirm and take into account final materiality level(s)
- Determine the method to quantify and evaluate uncorrected misstatements
- Evaluate uncorrected misstatements individually and in combination with other misstatements
- Evaluate uncorrected misstatements taking into account quantitative and qualitative factors
- Evaluate the effect of prior-period uncorrected misstatements.

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