AU-C Section 450

Evaluation of Misstatements Identified During the Audit

Source: SAS No. 122.

Effective for audits of financial statements for periods ending on or after December 15, 2012.

NOTE

In May 2019, the Auditing Standards Board (ASB) issued SAS No. 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*, which contains amendments to this section. In July 2019, the ASB issued SAS Nos. 136, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA*, and 137, *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports*, which also contains amendments to this section.

- The amendments in SAS No. 134 are effective for audits of financial statements for periods ending on or after December 15, 2020, and can be viewed in appendix A of section 700 until the effective date, when they will be applied to this section.
- The amendments in SAS No. 136 are effective for audits of financial statements for periods ending on or after December 15, 2020, and can be viewed in appendix C of section 703 until the effective date, when they will be applied to this section.
- The amendments in SAS No. 137 are effective for audits of financial statements for periods ending on or after December 15, 2020, and can be viewed in the appendix of section 720 until the effective date, when they will be applied to this section.

Introduction

Scope of This Section

.01 This section addresses the auditor's responsibility to evaluate the effect of identified misstatements on the audit and the effect of uncorrected misstatements, if any, on the financial statements. Section 700A, *Forming an Opinion and Reporting on Financial Statements*, addresses the auditor's responsibility in forming an opinion on the financial statements based on the evaluation of the audit evidence obtained. The auditor's conclusion, required by section 700A, takes into account the auditor's evaluation of uncorrected misstatements, if any, on the financial statements, in accordance with this section. Section 320, *Materiality in Planning and Performing an Audit*, addresses the auditor's responsibility to appropriately apply the concept of materiality in planning and performing an audit of financial statements.

Effective Date

.02 This section is effective for audits of financial statements for periods ending on or after December 15, 2012.

Objective

.03 The objective of the auditor is to evaluate the effect of

a. identified misstatements on the audit and

b. uncorrected misstatements, if any, on the financial statements.

Definitions

.04 For purposes of generally accepted auditing standards, the following terms have the meanings attributed as follows:

Misstatement. A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be presented fairly in accordance with the applicable financial reporting framework. Misstatements can arise from fraud or error. (Ref: par. .A1)

Misstatements also include those adjustments of amounts, classifications, presentations, or disclosures that, in the auditor's professional judgment, are necessary for the financial statements to be presented fairly, in all material respects.

Uncorrected misstatements. Misstatements that the auditor has accumulated during the audit and that have not been corrected.

Requirements

Accumulation of Identified Misstatements

.05 The auditor should accumulate misstatements identified during the audit, other than those that are clearly trivial. (Ref: par. .A2–.A3)

Consideration of Identified Misstatements as the Audit Progresses

.06 The auditor should 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: par. .A4)

b. the aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with section 320.[1] (Ref: par. .A5)

Communication and Correction of Misstatements

.07 The auditor should communicate on a timely basis with the appropriate level of management all misstatements accumulated during the audit. The auditor should request management to correct those misstatements. (Ref: par. .A6–.A8)

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[1] Paragraph .10 of section 320, *Materiality in Planning and Performing an Audit*.

.08 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 should perform additional audit procedures to determine whether misstatements remain. (Ref: par. .A9–.A11)

.09 If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor should obtain an understanding of management's reasons for not making the corrections and should take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement.[2] (Ref: par. .A12–.A15)

Evaluating the Effect of Uncorrected Misstatements

.10 Prior to evaluating the effect of uncorrected misstatements, the auditor should reassess materiality[3] to confirm whether it remains appropriate in the context of the entity's actual financial results. (Ref: par. .A16–.A18)

.11 The auditor should determine whether uncorrected misstatements are material, individually or in the aggregate. In making this determination, the auditor should 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: par. .A19–.A24 and .A26–.A27)
- *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: par. .A25)

Documentation

.12 The auditor should include in the audit documentation[4] (Ref: par. .A28)

- *a.* the amount below which misstatements would be regarded as clearly trivial; (See paragraph .05)
- *b.* all misstatements accumulated during the audit and whether they have been corrected; and (See paragraphs .05–.07)
- *c.* the auditor's conclusion about whether uncorrected misstatements are material, individually or in the aggregate, and the basis for that conclusion. (See paragraph .11)

Application and Other Explanatory Material

Definitions

Misstatement (Ref: par. .04)

.A1 Misstatements may result from fraud or error, such as

- *a.* an inaccuracy in gathering or processing data from which the financial statements are prepared,
- *b.* an omission of an amount or disclosure,

[2] Paragraph .14 of section 700A, *Forming an Opinion and Reporting on Financial Statements*.

[3] Paragraph .12 of section 320.

[4] Paragraphs .08–.12 and .A8 of section 230, *Audit Documentation*.

c. a financial statement disclosure that is not presented in accordance with the applicable financial reporting framework,

d. an incorrect accounting estimate arising from overlooking or clear misinterpretation of facts, and

e. judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection or application of accounting policies that the auditor considers inappropriate.

Other examples of misstatements arising from fraud are provided in section 240, *Consideration of Fraud in a Financial Statement Audit*.[5]

Accumulation of Identified Misstatements (Ref: par. .05)

.A2 The auditor may designate an amount below which misstatements would be clearly trivial and would not need to be accumulated because the auditor expects that the accumulation of such amounts clearly would not have a material effect on the financial statements. "Clearly trivial" is not another expression for "not material." Matters that are clearly trivial will be of a wholly different (smaller) order of magnitude than materiality determined in accordance with section 320 and will be matters that are clearly inconsequential, whether taken individually or in the aggregate and whether judged by any criteria of size, nature, or circumstances. When there is any uncertainty about whether one or more items are clearly trivial, the matter is considered not to be clearly trivial.

.A3 To assist the auditor in evaluating the effect of misstatements accumulated during the audit and in communicating misstatements to management and those charged with governance, the auditor may find it useful to distinguish between factual misstatements, judgmental misstatements, and projected misstatements, described as follows:

- *Factual misstatements* are misstatements about which there is no doubt.
- *Judgmental misstatements* are differences arising from the judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection or application of accounting policies that the auditor considers inappropriate.
- *Projected misstatements* are the auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire population from which the samples were drawn. Guidance on the determination of projected misstatements and evaluation of the results is set out in section 530, *Audit Sampling*.[6]

Consideration of Identified Misstatements as the Audit Progresses (Ref: par. .06)

.A4 A misstatement may not be an isolated occurrence. Evidence that other misstatements may exist include, for example, when 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.

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[5] Paragraphs .A1–.A8 of section 240, *Consideration of Fraud in a Financial Statement Audit*.

[6] Paragraphs .13–.14 of section 530, *Audit Sampling*.

.A5 If the aggregate of misstatements accumulated during the audit approaches materiality,[7] a greater than acceptably low level of risk may exist that possible undetected misstatements, when taken with the aggregate of uncorrected misstatements accumulated during the audit, could exceed materiality. Undetected misstatements could exist because of the presence of sampling risk and nonsampling risk.[8]

Communication and Correction of Misstatements (Ref: par. .07–.09)

.A6 Timely communication of misstatements to the appropriate level of management is important because it enables management to evaluate whether the items are misstatements, inform the auditor if it disagrees, and take action as necessary. Ordinarily, the appropriate level of management is the one that has responsibility and authority to evaluate the misstatements and take the necessary action.

.A7 Law or regulation may restrict the auditor's communication of certain misstatements to management or others within the entity. For example, laws or regulations may specifically prohibit a communication or other action that might prejudice an investigation by an appropriate authority into an instance of noncompliance or suspected noncompliance with laws or regulations. In some circumstances, potential conflicts between the auditor's obligations of confidentiality and obligations to communicate may be complex. In such cases, the auditor may consider seeking legal advice.

.A8 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.

.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 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.

.A10 The auditor may request management to record an adjustment needed to correct all factual misstatements, including the effect of prior period misstatements (see paragraph .08), other than those that the auditor believes are clearly trivial.

.A11 When the auditor has identified a judgmental misstatement involving differences in estimates, such as a difference in a fair value estimate, the auditor may request management to review the assumptions and methods used in developing management's estimate.

.A12 Section 700A requires the auditor to evaluate whether the financial statements are presented fairly, in all material respects, in accordance with the requirements of the applicable financial reporting framework.[9] This evaluation

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[7] Paragraph .12 of section 320.

[8] Paragraph .05 of section 530.

[9] Paragraph .13 of section 700A.

includes consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments, which may be affected by the auditor's understanding of management's reasons for not making the corrections (see section 700A).[10]

.A13 Section 580, *Written Representations*, addresses management representations, including representations with respect to uncorrected misstatements.[11]

.A14 In accordance with section 265, *Communicating Internal Control Related Matters Identified in an Audit*, identification by the auditor of a material misstatement of the financial statements under audit in circumstances that indicate that the misstatement would not have been detected by the entity's internal control is an indicator of a material weakness.[12]

.A15 Section 260, *The Auditor's Communication With Those Charged With Governance*, addresses matters to be communicated by the auditor to those charged with governance, including uncorrected misstatements.

Evaluating the Effect of Uncorrected Misstatements (Ref: par. .10–.11)

.A16 The auditor's determination of materiality in accordance with section 320 often is based on estimates of the entity's financial results because the actual financial results may not yet be known.[13] Therefore, prior to the auditor's evaluation of the effect of uncorrected misstatements, it may be necessary to revise materiality determined in accordance with section 320 based on the actual financial results.

.A17 Section 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.[14] 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 section 320 (see paragraph .10 of this section) 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 in order to obtain sufficient appropriate audit evidence on which to base the audit opinion.

.A18 Materiality is determined based on the auditor's understanding of the user needs and expectations (see section 320).[15] Although user expectations may differ based on inherent uncertainty associated with the measurement of particular items in the financial statements, these expectations have already been considered in the auditor's determination of materiality. For example, the fact that the financial statements include very large provisions with a high degree of estimation uncertainty (for example, provisions for insurance claims in the case of an insurance company; oil rig decommissioning costs in the case of

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[10] Paragraph .15 of section 700A.

[11] Paragraph .14 of section 580, *Written Representations*.

[12] Paragraph .A11 of section 265, *Communicating Internal Control Related Matters Identified in an Audit*.

[13] Paragraph .10 of section 320.

[14] Paragraph .12 of section 320.

[15] Paragraph .10 of section 320.

an oil company; or, more generally, legal claims against an entity) may influence the auditor's assessment of what users might consider material. However, after materiality is reassessed, this section requires the auditor to evaluate any misstatements in accordance with that level of materiality, regardless of the degree of inherent uncertainty associated with the measurement of particular items in the financial statements.

.A19 Each individual misstatement is considered to evaluate its effect on the relevant classes of transactions, account balances, or disclosures, including whether the materiality level for that particular class of transactions, account balance, or disclosure, if any, has been exceeded.

.A20 The auditor is required by section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, to evaluate the effect on the group audit opinion of any uncorrected misstatement identified by the group engagement team or communicated by the component auditors.[16]

.A21 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. The auditor may need to reassess the risks of material misstatement for a specific account balance or class of transactions upon identification of a number of immaterial misstatements within that account balance or class of transactions.

.A22 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 subtotals, or the effect on key ratios. Circumstances may exist in which 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.

.A23 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

[16] Paragraph .44 of section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*.

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 with regard to the auditor's understanding of known previous communications to users (for example, regarding 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 that, in the professional judgment of the auditor, is important to the users' understanding of the financial position, financial performance, or cash flows of the entity.
- affects other information that will be communicated in documents containing the audited financial statements (for example, information to be included in a "Management Discussion and Analysis" or an "Operating and Financial Review") that may reasonably be expected to influence the economic decisions of the users of the financial statements. Section 720A, *Other Information in Documents Containing Audited Financial Statements*, addresses the auditor's consideration of other information, on which the auditor has no obligation to report, in documents containing audited financial statements.
- is a misclassification between certain account balances affecting items disclosed separately in the financial statements (for example, misclassification between operating and nonoperating income or recurring and nonrecurring income items or a misclassification between restricted and unrestricted resources in a not-for-profit entity).
- offsets effects of individually significant but different misstatements.
- is currently immaterial and likely to have a material effect in future periods because of a cumulative effect, for example, that builds over several periods.
- is too costly to correct. It may not be cost beneficial for the client 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.

- represents a risk that possible additional undetected misstatements would affect the auditor's evaluation.
- changes a loss into income or vice versa.
- heightens the sensitivity of the circumstances surrounding the misstatement (for example, the implications of misstatements involving fraud and possible instances of noncompliance with laws or regulations, violations of contractual provisions, and conflicts of interest).
- has a significant effect relative to reasonable user needs (for example,
  - — earnings to investors and the equity amounts to creditors,
  - — the magnifying effects of a misstatement on the calculation of purchase price in a transfer of interests [buy-sell agreement], and
  - — the effect of misstatements of earnings when contrasted with expectations).
- relates to the definitive character of the misstatement (for example, the precision of an error that is objectively determinable as contrasted with a misstatement that unavoidably involves a degree of subjectivity through estimation, allocation, or uncertainty).
- indicates the motivation of management (for example, [i] an indication of a possible pattern of bias by management when developing and accumulating accounting estimates, [ii] a misstatement precipitated by management's continued unwillingness to correct weaknesses in the financial reporting process, or [iii] an intentional decision not to follow the applicable financial reporting framework).

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.

.A24 Section 240 explains how the implications of a misstatement that is, or may be, the result of fraud are required to be considered with regard to other aspects of the audit, even if the size of the misstatement is not material in relation to the financial statements.[17]

.A25 The cumulative effect of immaterial uncorrected misstatements related to prior periods may have a material effect on the current period's financial statements. Different acceptable approaches to the auditor's evaluation of such uncorrected misstatements on the current period's financial statements are available. Using the same evaluation approach provides consistency from period to period.

Considerations Specific to Governmental Entities

.A26 In the case of an audit of a governmental entity, the evaluation of whether a misstatement is material also may be affected by the auditor's responsibilities established by law or regulation to report specific matters, including, for example, fraud.

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[17] Paragraph .35 of section 240.

.A27 Furthermore, issues such as public interest, accountability, integrity, and ensuring effective legislative oversight, in particular, may affect the assessment of whether an item is material by virtue of its nature. This is particularly so for items that relate to compliance with law or regulation.

Documentation (Ref: par. .12)

.A28 The auditor's documentation of uncorrected misstatements may take into account the following:

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

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)

