Evaluating misstatements and evidence

MODULE 3 | 3.8 | STUDENT COMPANION

Throughout fieldwork the auditor **accumulates** every misstatement that isn't clearly trivial and **classifies** it as factual, judgemental or projected. All of them go to management with a request for **correction**. Corrections can change the numbers materiality was based on, so materiality may need **revising**; and the **nature** of a misstatement can change the plan even after it is fixed. Finally the auditor asks whether the risk assessments still hold and the evidence is **sufficient and appropriate**.

Accumulating misstatements

A misstatement is recorded on the **schedule of misstatements** unless it is **clearly trivial**: so small, and so unremarkable in nature, that it clearly couldn't matter even when added to the others. If there is any doubt, an item is not treated as clearly trivial. Clearly trivial is a much lower bar than immaterial; at Voltana it was set at 5% of materiality, $30,000 at planning.

Three kinds of misstatement

Accumulate every misstatement found, unless it is clearly trivial (for Voltana, originally below $30,000). If there is any doubt, an item is not treated as clearly trivial.

Factual	Judgemental	Projected
No doubt about it. For example, a sale recorded in the wrong year	Differences from management's judgements on recognition, measurement, presentation or disclosure, including the choice or application of accounting policies, that the auditor considers unreasonable or inappropriate	The auditor's best estimate of misstatement in a population, extrapolated from a sample
At Voltana Revenue cut-off: about $1.2 million	**At Voltana** Inventory write-down $0.3 million; warranty provision at least $0.6 million	**At Voltana** Receivables not tested: about $18,000

All go on one schedule of misstatements: recorded, classified, totalled and evaluated

Voltana's schedule of misstatements

	Item	Kind	Amount	Management
1	**Revenue cut-off.** June revenue for installations not done by 30 June, all through the CFO's manual journals	Factual	about $1.2 million	Corrects
2	**Inventory.** Older models carried at $2.1 million; sales after year end support $1.8 million	Judgemental	$0.3 million	Corrects
3	**Warranty.** Auditor's range $18.6 million to $20.4 million; management's figure $18 million	Judgemental	at least $0.6 million	Corrects, to $18.6 million
4	**Receivables.** $210,000 of cancellation credits never processed, plus other sample errors	Factual and projected	about $226,000 + about $18,000	Corrects the $226,000
5	**Disclosures.** The lease called arm's length; the CFO's brother's business left out	Disclosure	No amount	Corrects

Left uncorrected: projected receivables about $18,000 + an understated accrual of about $22,000 (kept on the schedule because it sits close to the clearly trivial threshold) = **$40,000**

Reading the schedule. The warranty misstatement is measured to the **nearest point** of the auditor's range: management's $18 million sits below a range of $18.6 million to $20.4 million, so the misstatement is at least $0.6 million. The receivables item mixes kinds: $226,000 found and certain, plus about $18,000 projected onto the balances that weren't tested. The disclosure item has no amount, but it still has to be fixed.

Communicating and correcting

The auditor must tell management about **all** accumulated misstatements on a timely basis and ask for them to be corrected. Voltana's management corrects all five items, so what remains is small: the projected receivables misstatement of about $18,000 and an understated accrual of about $22,000, which the team kept on the schedule because it sits close to the threshold: $40,000 in total. Had management refused, the auditor would have sought to understand why and taken those reasons into account in judging whether the statements are free from material misstatement.

Why the evaluation isn't over

Corrections reduce profit	
Profit before tax, as first measured	**$12.0m**
Revenue cut-off	- $1.2m
Inventory write-down	- $0.3m
Warranty provision	- $0.6m
Receivables	- $0.2m
After corrections	**about $9.7m**

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So materiality is revised

Threshold	At planning	Revised
Overall materiality (5% of profit before tax)	$600,000	**about $480,000**
Performance materiality (60%)	$360,000	**about $290,000**
Clearly trivial (5% of materiality)	$30,000	**about $24,000**

Then ask: is the work already done still enough?

Most of it is, because it was planned with the higher amounts in mind; the team extends testing where samples were designed around the old thresholds

Revising materiality. Materiality was 5% of a profit before tax of $12 million. The corrections total about $2.3 million ($1.2m + $0.3m + $0.6m + $0.226m), leaving about $9.7 million, and 5% of that is a little over $480,000. Because the team would have set a lower amount had it known the true profit at the start, it revises all three thresholds and checks whether work planned with the higher amounts is still enough.

When the nature matters more than the size

A corrected misstatement can still change the audit, because of what it reveals about people and controls. The auditor revisits the audit strategy and plan when the nature of misstatements suggests others may exist. At Voltana, revenue overstated through the CFO's own manual journals, together with an undisclosed business owned by a family member and paid above-market rates, points towards possible intentional misstatement. So the team:

- extends its testing to every manual journal the CFO posted;
- reconsiders how much weight to place on the CFO's representations;
- considers whether legal advice is needed; and
- plans to raise the matter with the audit committee.

The final questions before completion

Voltana's remaining $40,000 is well below the revised materiality of about $480,000, so on the numbers alone it wouldn't change the opinion. Module 4 takes the story to completion.

Question	What the auditor does
Do the risk assessments still hold?	Revisits them in the light of what fieldwork found, and changes the plan if they don't
Is the evidence sufficient and appropriate for every material area?	Obtains more if not; if it can't be obtained, considers the effect on the opinion
Are the uncorrected misstatements material?	Judges them individually and in total, by size and nature; tells those charged with governance and asks again for correction
What does management say?	Obtains written confirmation that management believes the uncorrected misstatements are immaterial, individually and in total, with a summary of them included in the letter

Practice questions

MODULE 3 | 3.8 | TRY THESE BEFORE THE WORKED ANSWERS

Question 1 - Classify the misstatements

Tolhurst Racking Ltd (imagined) makes steel storage racking for warehouses and has a 30 June year end. Classify each misstatement found during the audit, and state its amount and its effect on profit.

Misstatement	Factual, judgemental or projected?	Amount and effect
(a) Repairs to the factory roof, $64,000, were finished on 24 June, but the invoice was recorded in July		
(b) A sale of $85,000 was recorded on 29 June, but the racking was dispatched on 3 July; it cost $55,000 to make and was still on hand at 30 June		
(c) Management's allowance for expected credit losses is $40,000; the auditor's range, based on ageing and receipts after year end, is $90,000 to $110,000		
(d) A sample of inventory lines covering 8% of inventory value had pricing errors of $3,100 (overstated); the auditor's best estimate for the whole of inventory is $38,750		
(e) $48,000 spent on a new racking design was capitalised, but the auditor considers the project still at the research stage		
(f) Timesheets covering 5% of June overtime showed $1,200 not accrued; the auditor's best estimate for all of June's overtime is $24,000		

Question 2 - Are the uncorrected misstatements material?

Tolhurst's schedule of misstatements is below. After management's corrections, profit before tax is $3,240,000. The auditor set materiality at $160,000. The managing director is paid a bonus if profit before tax reaches $3,200,000. Decide whether the uncorrected misstatements are material, considering both their size and their nature.

Item	Amount (overstates profit)	Corrected?
(a) Roof repairs not accrued	$64,000	Yes
(b) Sale recorded before dispatch	$30,000	Yes
(c) Expected credit losses	$50,000	No: 'just a difference of opinion'
(d) Inventory pricing	$3,100 found; $35,650 projected	Only the $3,100
(e) Research costs capitalised	$48,000	Yes
(f) Overtime accrual	$1,200 found; $22,800 projected	Only the $1,200

Question 3 - Management refuses

Tolhurst's finance director refuses to adjust the allowance for expected credit losses, saying the $50,000 difference is immaterial and 'just a matter of opinion'. How should the auditor respond?

Worked answers

MODULE 3 | 3.8 | WORKED ANSWERS - ATTEMPT THE QUESTIONS FIRST

Question 1 - Classification

	Kind	Amount and effect
(a)	Factual	$64,000: expenses and payables understated; profit overstated by $64,000
(b)	Factual	Revenue and receivables overstated by $85,000; the goods ($55,000) belong in inventory, so profit is overstated by $30,000
(c)	Judgemental (estimate)	At least $50,000, the gap to the nearest point of the range: receivables overstated, profit overstated
(d)	Factual and projected	$3,100 factual plus $35,650 projected for the untested lines: inventory and profit overstated by $38,750 in total
(e)	Judgemental (policy)	$48,000: research costs must be expensed, so intangible assets and profit are overstated
(f)	Factual and projected	$1,200 factual plus $22,800 projected: accrued expenses understated, profit overstated by $24,000 in total

Question 2 - Material?

- **Size.** Uncorrected: (c) $50,000 + (d) $35,650 + (f) $22,800 = **$108,450**, all overstating profit: about two-thirds of materiality, so not material on size alone, though the projected amounts carry sampling risk and the true figure could be higher.
- **Nature.** Without the uncorrected items, profit before tax would be about $3,131,550, below the $3,200,000 bonus hurdle. They decide whether the managing director is paid a bonus, and the refusal to adjust the most judgemental item, in management's favour, hints at bias.
- **Conclusion.** Material by nature. Ask again for correction and tell those charged with governance; if they stay uncorrected, the opinion is qualified ('except for'), not unmodified.

Question 3 - Management refuses

- **Understand the reasons.** Is there new evidence, or only a preference for the lower figure? If the range still holds after re-checking receipts after year end, the misstatement stands.
- **Reassess materiality**, then evaluate the uncorrected misstatements individually and in total, with any from prior periods, by size and nature, including the bonus hurdle and possible bias.
- **Communicate** them to those charged with governance, asking for correction and explaining the effect on the auditor's report.
- **Get a written representation** that management believes the uncorrected misstatements are immaterial, individually and in total, with a summary of them included in the letter; it doesn't replace the auditor's own judgement.
- **If they are material**, modify the opinion (qualified, or adverse if pervasive), consider what the refusal says about management's integrity, and document the evaluation.