



May 11, 2005

Mr. Jim Sylph
Technical Director
International Federation of Accountants
545 Fifth Avenue, 14th Floor
New York, NY 10017

Dear Mr. Sylph:

We appreciate this opportunity to comment on the proposed revised International Standard on Auditing (ISA) 320, *Materiality in the Identification and Evaluation of Misstatements* (the “exposure draft” or the “proposed standard”) as developed by the International Auditing and Assurance Standards Board (IAASB). We are strongly supportive of the development of this guidance, as we believe further guidance in this area is much needed. We commend the IAASB for undertaking such a difficult project, one which we believe will result in greater consistency in the application of theoretical concepts to actual audit engagements. However, we do have some recommendations for clarifying the proposed standard, as described below. In addition, when issuing the final standard, we believe it would be valuable to describe how the issuance of this standard will be beneficial to the users of the financial statements.

As requested in the explanatory memorandum of the exposure draft, this letter includes our comments regarding the audits of small entities and public sector entities, as well as other comments on specific paragraphs within the exposure draft. Within our recommendations for editorial changes, additions are noted in “bold underline” and deletions in “double strike-through.”

Request for Specific Comments – Special Consideration in the Audit of Small Entities:

We suggest that the IAASB consider including additional specific guidance in the following areas for audits of small entities:

-Management bias in small entities may result from different motives - for example, there may be a bias to *reduce profit* to pay less tax, which is different to the usual motive for larger entities to *increase profit* to meet shareholder expectations.

-Benchmark guidelines for smaller entities may be different from larger entities, as smaller entities may have different shareholding structures or different users of the financial statements. As noted in the comments to paragraph 14 (see below), we suggest that the benchmark examples provided be changed from fixed percentages to a range of percentages (for example, five to ten percent of profit before tax). Based on the entity's size and other engagement circumstances, the auditor will use professional judgment to determine the point in the range which is appropriate for determining materiality for each specific engagement.

Request for Specific Comments – Special Consideration in the Audit of Public Sector Entities:

The public sector perspective paragraphs use the word “should.” We do not believe this is appropriate, and recommend revising these paragraphs to be written in the present tense.

Other Comments – Listed by Paragraph:

• Paragraph 2

This paragraph states that the auditor should consider materiality in reducing audit risk to an acceptably low level. By definition, audit risk is measured given a set materiality. We believe that the requirement to consider materiality *to reduce audit risk* could be misinterpreted to mean that one option to reduce audit risk would be to set materiality exceptionally high, thus making audit risk very low. As paragraph 15 of ISA 200 already requires the auditor to plan and perform the audit to reduce audit risk to an acceptably low level, we recommend the following edits to reduce any unintended confusion:

2. The auditor should consider materiality when planning and performing the audit ~~to reduce audit risk to an acceptably low level that is consistent with the objective of an audit.~~

• Paragraphs 6 and 35:

Both of these paragraphs state that the auditor considers the nature of an item, as well as the size of the item, in determining whether the item is material or not. We suggest that the IAASB include specific guidance that, when the auditor considers both qualitative and quantitative factors, the auditor selects the lower outcome when determining and evaluating materiality.

• Paragraph 7:

This paragraph states that if the applicable financial reporting framework provides a definition of materiality which is different from the one described in paragraph 6, the auditor uses that definition for the purpose of the audit. We believe that regardless of the definition of materiality used, the auditor should always consider the nature of an item (qualitative factors) in determining whether an item is material or not. We suggest including some grey letter guidance in paragraph

7 regarding the importance of qualitative factors, even if the definition of materiality in the applicable financial reporting framework does not include a reference to qualitative factors.

- **Paragraph 11:**

We suggest the edit below, as it would clarify that the items described in this paragraph relate to the planning phase of the audit (i.e., “evaluation of misstatements” is not included in this list because it does not relate to planning):

11. **When planning the audit,** The auditor should determine a materiality level for the financial statements as a whole for the purpose of:...

- **Paragraph 13:**

We suggest adding the factor below to the list of factors the auditor has regard to when *identifying* an appropriate benchmark. While volatility is mentioned in the text after the bullets, such placement makes it almost an “afterthought” once a benchmark has already been selected, when in practice, it is critical to consider an potential benchmark’s volatility when deciding whether or not to select it. The issue of volatility will become more important as fair value accounting and other accounting framework changes (for example, accounting for the cost of share options) gain widespread use and increase the amount of volatility in financial statements around the globe.

The relative volatility or stability of the benchmark.

- **Paragraph 14:**

We are concerned that the inclusion of specific percentages in the proposed standard will make the determination of materiality a formulaic exercise. In order to highlight the fact that the determination of materiality is based on the auditor’s professional judgment and not simply the application of a formula, instead of providing *fixed* percentages in the examples in paragraph 14, we suggest including a *range* of percentages for the benchmarks. This also will allow for the expected variation in percentages used for different types of entities or in response to different user groups. Additionally, we suggest that the IAASB consider including a sentence at the end of this paragraph which states that benchmarks selected may also vary by industry. Accordingly, we suggest the following edits to paragraph 14:

14. **Depending on the nature and circumstances of the audit,** Illustrative examples of percentages applied to benchmarks that might be considered include the following:

- For a profit oriented entity, five **to ten** percent of profit before tax from continuing operations, or one half of one percent **to three percent** of total revenues.

- For a not-for-profit entity, one half of one percent **to three percent** of total expenses or total revenues.

- For an entity in the mutual fund industry, one half of one percent **to two percent** of net asset value.

Although the benchmarks illustrated above may be used by the auditor as a guide to determine materiality, the auditor uses professional judgment to determine whether the materiality calculated using any benchmark is appropriate for the entity. The illustrative benchmarks are not applied by the auditor in a purely formulaic manner without the auditor applying professional judgment based on the nature and circumstances of the audit. Additionally, the auditor may consider higher or lower percentages than those illustrative above to be appropriate and benchmarks used may also vary by industry.

- **Paragraph 17:**

This paragraph requires that the auditor consider whether “misstatements of particular items of lesser amounts than the materiality level determined for the financial statements” could affect the economic decisions of users. The guidance at the end of this paragraph goes on to say that this lower materiality level is “to be considered” in relation to the particular item, but does not define or further explain what is meant by “to be considered.”

We suggest that the IAASB clarify whether this “lower materiality level” is used only in the *evaluation of misstatements* phase of the audit, or if it were also intended to be used in *determining the nature, timing and extent of further audit procedures*. We are concerned that if the latter applies, the auditor may not appropriately scope his or her work on other accounts or classes of transactions that may be affected by the particular which requires a lower materiality level. For example, what materiality level is used to scope the work on receivables if revenue is determined to be an item requiring a lower materiality level? How can the auditor ensure that he or she is appropriately scoping the work, when a misstatement in revenue could only be discovered through audit procedures on a different account or class of transactions? Should the auditor always use the lowest materiality level to scope the entire audit?

Additionally, we suggest including clarification as to what is meant by the phrase “particular items.” Are there items which may be misstated that are not “account balances, classes of transactions or disclosures?” If so, please include some examples so that readers can fully understand what was intended to be included by the use of this phrase.

- **Paragraphs 20 and 21:**

Terminology

Given that *misstatements* may be due to *error* or *fraud* (see paragraphs 4-5), we recommend that the term “tolerable error” be replaced by “tolerable misstatement”. Conforming changes should then be made in ISA 530, paragraph 12, and elsewhere as necessary.

Ambiguity

Paragraph 20 states that “The auditor should determine one or more levels of tolerable misstatement for classes of transactions, account balances and disclosures.” However, paragraph 21 then refers to paragraph 17 where it is contemplated that the auditor may establish more than one materiality level when there are one or more particular items that warrant materiality levels lower than the materiality level determined for the financial statements as a whole. We believe that the wording of paragraph 21 is somewhat ambiguous, or is at least prone to being misunderstood, and should therefore be clarified.

One possible interpretation, which we believe to be wrong, is that multiple levels of tolerable misstatement are only required when there are multiple materiality levels as contemplated in paragraph 17. Another interpretation, which we believe to be the correct and intended one, is that multiple levels of tolerable misstatement may be necessary for classes of transactions and account balances to ensure that the aggregate misstatement in the financial statements is not material. In other words, even if there are no paragraph 17-type lower materiality levels, it may still be necessary to establish more than one level of tolerable misstatement for classes of transactions, account balances or disclosures.

The ambiguity arises because multiple tolerable misstatement levels may be necessitated by multiple materiality levels (paragraph 17), by multiple classes of transactions and account balances, or by both. We recommend that paragraph 21 be reworded to deal with materiality at the financial statement level, and that another paragraph, paragraph 21A, deal with lower materiality levels determined in accordance with paragraph 17.

Determination of tolerable misstatement levels

Stripping out paragraph 17 considerations for the sake of simplicity, paragraph 21 states that “the auditor allows for the possibility that some misstatements of lesser amounts than [materiality]... could, in the aggregate, result in a material misstatement of the financial statements. To do so, the auditor determines one or more levels of tolerable misstatement.”

We believe that it would be helpful if the IAASB were to indicate, in general terms if necessary, how tolerable misstatement levels may be determined and how they relate to materiality. We think that the key concept linking tolerable misstatement and materiality is that of *audit risk*. Specifically, we recommend that paragraph 21 be recast to make the point that tolerable misstatement levels should be set for classes of transactions and account balances in such a way that if the risks that such levels could be exceeded are acceptably low then, in aggregate, the risk that the total misstatement in the financial statements could exceed materiality will also be acceptably low. Such a formulation establishes the general principle that there is a relationship between materiality, tolerable misstatement and audit risk; and it is a formulation that can be operationalized for deployment in practice.

We also recommend that the last sentence in paragraph 21 be made a bold-lettered requirement.

To address our comments on paragraphs 20 and 21, we recommend the following edits be made:

20. The auditor should determine one or more levels of tolerable ~~error~~**misstatement** for classes of transactions, account balances and disclosures.

21. When assessing the risks of material misstatements and designing and performing further audit procedures to respond to the assessed risks, the auditor allows for the possibility that some misstatements of lesser amounts than the materiality levels determined ~~in accordance with paragraphs 14 and 17~~ **for the financial statements as a whole** could, in the aggregate, result in a material misstatement of the financial statements. To do so, the auditor determines one or more levels of tolerable ~~error~~ **misstatement for classes of transactions and account balances in such a way that, if the risk that such classes of transactions or account balances contain misstatements in excess of tolerable misstatement is acceptably low, then in aggregate, the risk that the total misstatement in the financial statements could exceed materiality will also be acceptably low.** Such levels of tolerable ~~error~~ **misstatement** ~~are~~ **should be** lower than the materiality levels **determined for the financial statements as a whole.**

21A. When a lower materiality level is set for a particular item in accordance with paragraph 17, the auditor determines one or more levels of tolerable misstatement for classes of transactions and account balances related to that item in such a way that, if the risk that such transactions or balances contain misstatements in excess of tolerable misstatement is acceptably low, then, in aggregate, the risk that the total misstatement in the particular item could exceed the materiality level determined for that item will also be acceptably low. Such levels of tolerable misstatement should be lower than the materiality level determined in accordance with paragraph 17 for the particular item.

- **Paragraph 27:**

We recommend removing the conditional clause at the beginning of this paragraph, as we believe the auditor should always go through the exercise of considering whether the risk that undetected misstatements could exceed the materiality level is acceptably low (see suggested edits below). Even if the total misstatements that have been identified are significantly lower than materiality, the auditor may still not be able to conclude that the risk of material misstatement in the financial statements is acceptably low.

~~If the aggregate of the misstatements that the auditor has identified approaches the materiality level,~~ **The auditor should consider whether there is a greater than acceptably low level of risk that undetected misstatements, when taken with the aggregate identified misstatements that have been accumulated, could exceed the materiality level and, if so, should reconsider the nature and extent of further audit procedures.**

• **Paragraph 28:**

As currently written, this paragraph combines the concepts of “accumulating” misstatements and “communicating” misstatements, which can be confusing to readers. For the purpose of clarity, we suggest that another section be included in the proposed standard, entitled “Accumulation of Misstatements.” We also recommend including in this section guidance from paragraph 54 of the old ISA 240 regarding the accumulation of misstatements, which was not included in the revised ISA 240. This section could be inserted before paragraph 22 and structured as follows:

Accumulation of Misstatements

21B. For purposes of communication and evaluation, the auditor accumulates misstatements identified during the audit, including those subsequently corrected by management, and distinguishes between:

(a) Known misstatements, separately identifying:

(i) Misstatements of fact

These are specific misstatements identified during the audit including, for example, those arising from mistakes in gathering or processing data and the overlooking or misinterpretation of facts; and

(ii) Misstatements involving subjective decisions

These arise from differences between management’s and the auditor’s judgments concerning accounting estimates (e.g., because an estimate included in the financial statements by management is outside of the reasonable range of outcomes the auditor has determined) or the selection and application of accounting policies that the auditor considers to give rise to misstatements; and

(b) Likely misstatements

These are misstatements that the auditor considers likely to exist based on an extrapolation from audit evidence obtained, for example the amount obtained by projecting known misstatements identified in an audit sample to the entire population from which the sample was drawn.

The auditor may designate an amount below which misstatements need not be accumulated because the auditor expects that the accumulation of such amounts clearly would not have a material effect on the financial statements even when aggregated and extrapolated because they are clearly trivial¹. In doing so, the

¹ This is not another expression for not material. Matters which are “clearly trivial” will be of a wholly different (smaller) order of magnitude than the materiality levels used in the audit, and will be matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances. Further, whenever there is any uncertainty about whether one or more items

auditor considers the fact that the determination of materiality involves qualitative as well as quantitative considerations and that misstatements of a relatively small amount could nevertheless have a material effect on the financial statements.

In addition to adding a new section on accumulation, the following edits to other paragraphs would be necessary, as follows (Note: changes related to this suggestion have also been made to paragraphs 27, 35 and 46, however, they have been combined with other recommendations related to those paragraphs – see comments on paragraphs 27, 35 and 46 elsewhere in this letter):

12. ...This materiality level does not, however, establish a threshold below which ~~identified~~ misstatements are always considered to be immaterial when evaluating those misstatements and their effect on the auditor's report. As discussed in paragraph 37, the circumstances related to some ~~identified~~ misstatements may cause the auditor to evaluate them as material even if they are below the materiality level determined when establishing the overall audit strategy.

25. The auditor should consider whether the overall audit strategy and audit plan need to be revised if the nature of ~~identified~~ misstatements **that have been accumulated**, and the circumstances of their occurrence, are indicative that other misstatements may exist that, when aggregated with ~~identified~~ misstatements **that have been accumulated**, could be material.

28. The auditor should ~~accumulate all known and likely misstatements identified during the audit, other than those that the auditor believes are clearly trivial [fn4], and communicate them~~ **all known and likely misstatements that have been accumulated** to the appropriate level of management on a timely basis. **The auditor may also communicate other identified misstatements, for example, clearly trivial misstatements, to the appropriate level of management.**

31. Delete (moved to new paragraph 21B).

32. The auditor should request management to correct all known misstatements **that have been accumulated**, ~~other than those that the auditor believes are clearly trivial.~~ ...

36. Before considering the aggregate effect of ~~identified~~ uncorrected misstatements **that have been accumulated**, the auditor considers each misstatement separately: ...

37. The circumstances related to some misstatements may cause the auditor to evaluate them as material, individually or when considered together with other ~~identified~~ misstatements **that have been accumulated**, even if they are of a lower level than the auditor had determined to be material when establishing the overall audit strategy. ...

40. ...The auditor may conclude that the cumulative effect of a lack of neutrality, together with uncorrected misstatements that have been ~~identified~~ **accumulated** during the audit, cause the financial statements as a whole to be materially misstated. ...

- **Paragraph 33:**

This paragraph should make clear that it is not sufficient for management to simply correct all of the likely misstatements identified by the auditor, without examining the class of transactions, account balance or disclosure themselves. In this situation, the auditor considers why management would refuse to perform such evaluation, and determine whether or not there is a scope limitation.

- **Section on Evaluating the Effect of Uncorrected Misstatements:**

We suggest that the IAASB include guidance in this section that, when evaluating identified misstatements, the auditor considers whether there are any tax consequences of the misstatements.

- **Paragraph 35:**

This paragraph states that the auditor should evaluate whether uncorrected misstatements are material, both in relation to the particular classes of transactions, account balances and disclosures, and the financial statements as a whole. We are concerned that this sentence may be read to mean that the auditor needs to evaluate whether accounts receivable is materially misstated on a stand-alone basis (evaluated with a materiality based on the balance of accounts receivable), *in addition* to determining whether the financial statements taken as a whole are materially misstated. In order to clarify that the intended meaning was for the auditor to consider each class of transaction, account balance and disclosure in relation to the financial statements as a whole, we recommend the following revisions:

35. The auditor should evaluate whether the uncorrected misstatements that have been **accumulated** ~~identified~~ during the audit are material, individually or in aggregate, **to the financial statements as a whole**. In making this evaluation, **in relation to particular classes of transactions, account balances and disclosures**, the auditor should consider the size and nature of the misstatements, ~~both in relation to particular classes of transactions, account balances and disclosures and the financial statements as a whole,~~ and the particular circumstances of their occurrence, **and determine the impact of such misstatements on the financial statements as a whole**.

- **Paragraph 36(c):**

We are concerned that some readers may interpret this paragraph to mean that the use of the “roll-over” method is required in evaluating the effect of uncorrected misstatements. Because the use of either the “iron curtain” or “roll-over” methods of evaluating uncorrected

misstatements is determined based on the requirements of the financial reporting framework, we suggest that the IAASB clarify its position that either method is acceptable and specifically state that the selection of methods is determined by the financial reporting framework..

- **Paragraph 39:**

This paragraph states that the auditor should consider the “qualitative aspects of the entity’s accounting practices,” but the corresponding grey-lettered guidance only discusses “management bias.” If there are other qualitative aspects of the accounting practices the auditor should consider, for example, selection of accounting policies and judgments about financial statement disclosures (see proposed ISA 260, “*The Auditor’s Communication with Those Charged with Governance*,” paragraphs 32, paragraph 34 and Appendix), we suggest that the IAASB include such and similar examples in the grey-lettered guidance, or make a reference to ISA 260. If the main focus of the bold letter was intended to be management bias, then we suggest rewording the second sentence of paragraph 39 to make reference to such, instead of to “qualitative aspects of the entity’s accounting practices.”

- **Paragraph 41:**

We recommend changing the word “believes” in the first sentence to “concludes.”

- **Paragraph 46(c):**

We believe that 46(c) is overly broad and onerous, as it contains no boundaries – it may cause auditors to document needless amounts of ratios and trends in an attempt to demonstrate compliance with the Standard. We suggest that the IAASB limit paragraph 46(c) to significant items or key ratios and trends. Accordingly, we recommend the following edits:

46(c) Assess the effect of misstatements on **significant** ~~particular~~ groups of accounts, segment information, **key ratios, or trends**, and compliance with legal, regulatory and contractual requirements (e.g., debt covenants).

- **Paragraph 46:**

We believe the following edits are appropriate to this paragraph, as the paragraph relates to “uncorrected” misstatements, not “all” (corrected and uncorrected) identified misstatements:

46. **Uncorrected** ~~misstatements~~ **that have been accumulated** are documented in a manner that allows the auditor to:

(a) *no changes proposed*

(b) Consider the effect of **uncorrected** misstatements **that have been accumulated** on the financial statements; and

(c) Assess the effect of **uncorrected** misstatements **that have been accumulated** on...

We would be pleased to discuss our letter with you or your staff at your convenience. If you have any questions, please contact P. Nicholas Fraser at + 1 (212) 492-4118.
Very truly yours,

/s/ Deloitte Touche Tohmatsu