



February 12, 2007

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 proposed International Standard on Auditing (ISA) 320 (Revised and Redrafted), *Materiality in Planning and Performing an Audit* and Proposed ISA 450 (Redrafted), *Evaluation of Misstatements Identified During the Audit* (the “proposed standards”) as developed by the International Auditing and Assurance Standards Board (IAASB). We are strongly supportive of the development of the proposed standards, as we believe further guidance in this area is much needed.

We recognize that the IAASB has requested comments only on changes resulting from applying the clarity drafting conventions. However, in addition to our comments on the clarity redrafting of the proposed standards, we have included a non-clarity comment on the requirement to consider the sufficiency of work performed (proposed ISA 450, paragraph 7) because we believe that its significance warrants the IAASB’s consideration. We are concerned that the paragraph will, in practice, result in seemingly “ISA-compliant” audits where risk has not been reduced to an acceptably low level – a fundamental audit objective. There are few tasks more important than determining whether the scope of the audit has been sufficient and paragraph 7 of ISA 450 is central to that determination. We have included suggested changes to the wording of the requirement below.

Within our recommendations for changes, additions are noted in “bold underline” and deletions in “double strike-through.”

### **Responses to Questions Posed in the Explanatory Memorandum**

1. *Is the objective to be achieved by the auditor, stated in each of the proposed redrafted ISAs, appropriate?*

We believe that the objectives, as stated, are appropriate.

2. *Have the criteria identified by the IAASB for determining whether a requirement should be specified been applied appropriately and consistently, such that the resulting requirements promote consistency in performance and the use of professional judgment by auditors?*

We believe that the clarity criteria identified by the IAASB for determining whether a requirement should be specified have been applied appropriately.

#### **Comment of Significance – Proposed ISA 450 – Paragraphs 7 and A4**

As we noted in our comment letter on the 2004 exposure draft of proposed ISA 320, *Materiality in the Identification and Evaluation of Misstatements*, we believe that the auditor should always go through the exercise of considering whether the risk that undetected misstatements could exceed the materiality level is acceptably low and considering whether the audit strategy and audit plan need to be revised, not just when the aggregate of accumulated misstatements approaches materiality. 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.

We therefore recommend that the first sentence of paragraph A4 be deleted, and that paragraph 7 be reworded as follows:

**7. The auditor shall determine whether there is a greater than acceptably low level of risk that undetected misstatements, when taken with the aggregate misstatements that have been accumulated, could exceed the materiality level or levels, and if so, shall evaluate whether the overall audit strategy and audit plan need to be revised.**

#### **Other Comments**

##### **Overall Terminology**

###### *Use of “consider”*

Our understanding of the clarity conventions to be used in redrafting the ISAs is that the redrafted standards will avoid the use of the term “consider” (in all forms) given its ambiguity, particularly when describing an auditor action.

While we recognize that the term may be appropriate in certain circumstances within the requirements of the proposed standards (and have in fact suggested its use in paragraph 10 to clarify the current drafting), in reading the proposed standards we noted frequent use of the term. For example, paragraphs 6, 13 and 19 contain requirements which include the term “consider”. We believe that the use of terms such as “evaluate”, “determine”, or “assess” in place of “consider” in each of these requirements would clarify the meaning of the requirement for the reader.

#### **Comments by Paragraph**

##### **Proposed ISA 320**

###### **• Paragraph 11**

We recommend including the first two sentences of paragraph A13 as essential explanatory material in paragraph 11. We believe that it may be difficult for the reader to understand the purpose for calculating an amount lower than the materiality level for the financial statements as a whole without providing the context for such a calculation, as described in the first two sentences of paragraph A13.

- **Paragraph 11**

In order to achieve consistency in wording between paragraph 9(c), paragraph 11 and paragraph 13 (see comment below) and to reconcile the wording in the proposed standard with the language in paragraph A11 of proposed ISA 450, we suggest the following changes:

“The auditor shall determine an amount or amounts lower than the materiality level for the financial statements as a whole...for purposes of assessing the risks of material misstatement and ~~designing further audit procedures to respond to assessed risks~~ **determining the nature, timing and extent of further audit procedures to obtain sufficient appropriate audit evidence on which to base the audit opinion.**”

- **Paragraph 13**

We recommend that the proposed standard include application material related to paragraph 13 advising that if the auditor lowers the material level or levels, he or she needs to reconsider the work previously performed at the initial (higher) materiality level to determine if the work performed at that higher level is sufficient.

In addition, as noted above in our comment on paragraph 11, in order to be consistent with the wording in paragraph 9 (c), paragraph 11 and to reconcile the wording in the proposed standard with the language in paragraph A11 of proposed ISA 450, we suggest the following changes:

“If the auditor concludes that lower materiality level or levels than that initially determined are appropriate, the auditor shall reconsider the lower amount or amounts determined for purposes of assessing the risks of material misstatement and ~~designing further audit procedures, and the appropriateness of~~ **determining** the nature, timing and extent of further audit procedures **to obtain sufficient appropriate audit evidence on which to base the audit opinion**”.

## **Proposed ISA 450**

- **Use of the term “accumulated”**

We noted inconsistent use of the term “accumulated” in the proposed standard. While certain requirements (e.g., paragraphs 6, 7 and 9) describe actions related to misstatements “accumulated during the audit”, other paragraphs do not use the modifier “accumulated” where we believe it should be used. For example, we suggest changing paragraph 13 as follows, to provide greater clarity about the intent of the requirement:

“The auditor shall evaluate whether **accumulated** uncorrected misstatements are material, individually or in the aggregate...”

We believe that similar changes should be made to the requirements in paragraphs 11 – 12, 14 – 15 and 17 – 18. We recommend that the IAASB perform an overall review of the requirements and application material of the proposed standard, and make the necessary changes to achieve consistency in the use of the term “accumulated”.

- **Paragraph 8**

We recommend the following editorial change:

“If management, in response to the auditor’s findings or at the auditor’s request, has examined a class of transactions, account balance or disclosure and corrected misstatements that were ~~found~~ **detected**, the auditor shall perform further audit procedures...”

- **Paragraphs 8 and 9**

We believe that the proposed standard should include additional application material describing the mechanics of how one would approach the requirements in paragraphs 8 and 9. Specifically, the guidance should address the reasons why an auditor may request management to investigate a class of transactions, account balance or disclosure when a misstatement has been identified. The guidance should also link the steps taken by the auditor and management to perform procedures related to misstatements identified (as described in paragraphs 8) and the auditor’s request for remaining accumulated misstatements to be corrected (as described in paragraph 9). Therefore, we recommend the following change:

A5. [Reference to paragraphs 8 and 9]

“The auditor may request management to examine a class of transactions, account balance or disclosure **in order for management to understand the nature of the misstatement identified, perform procedures to determine the amount of 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.

- **Paragraph 10**

We believe that it would be helpful to clarify the second requirement in paragraph 10 by adding guidance regarding what the auditor should consider when evaluating whether the financial statements as a whole are free of misstatement (currently there is no application material for this paragraph), and changing the wording of the requirement as follows:

“...the auditor shall obtain an understanding of management’s reasons for not making the corrections and shall ~~take that into account~~ **consider that understanding** when evaluating whether the financial statements as a whole are free from material misstatement”.

- **Paragraph 14**

We recommend the following change to clarify the meaning of the requirement:

“The auditor shall also ~~consider~~ **evaluate** the effect of **accumulated** uncorrected misstatements related to prior periods...”

- **Paragraph 15**

Paragraph 15 contains four requirements in three sentences. We suggest breaking the paragraph into two separate paragraphs for better readability and making the following changes to clarify the meaning of the requirements:

15. “The auditor shall communicate with those charged with governance **accumulated** uncorrected misstatements and the effect that they may have on the opinion in the

auditor's report, ~~and request their correction.~~ The written representation obtained from management in accordance with paragraph 11 shall form part of this communication. **For material accumulated uncorrected misstatements, the auditor shall communicate each misstatement individually.** ~~In communicating the effect that material uncorrected misstatements may have on the opinion in the auditor's report, the auditor shall address them individually.~~

15 A. **The auditor shall request those charged with governance to correct accumulated uncorrected misstatements.**

- **Paragraph A3**

We recommend that this paragraph be replaced with a cross-reference to the guidance in paragraph 50 of extant ISA 530, *Audit Sampling and Other Means of Testing*:

**"The auditor may be able to establish that an error arises from an isolated event that has not recurred other than on specifically identifiable occasions and is therefore not representative of similar errors in the population (an anomalous error). To be considered an anomalous error, the auditor has to have a high degree of certainty that such error is not representative of the population."**

- **Paragraph A11, third sentence**

Similar to our comment on paragraph 11 of proposed ISA 320, we suggest the following wording change for consistency between the two proposed standards:

"However, as explained in ISA 320, if the materiality level or levels are revised to lower amount or amounts, the lower amount or amounts determined for purposes of assessing **the** risks of material misstatements and ~~designing further audit procedures, and the appropriateness of~~ **determining** the nature, timing and extent of further audit procedures, are reconsidered to ~~ensure that~~ **determine whether** sufficient appropriate audit evidence ~~is obtained~~ on which to base the audit opinion **has been obtained**".

- **Paragraph A13**

Paragraph A13 employs present tense in such a way that there may be confusion as to whether the guidance actually represents requirements. We believe that re-ordering the sentences may assist the reader in identifying that these sentences are guidance rather than requirements. Therefore, we suggest that the paragraph read as follows:

"It may be appropriate to offset immaterial misstatements within an account balance or class of transactions; however, the risk that further undetected misstatements may exist is considered before concluding that offsetting such immaterial misstatements is appropriate. 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."

- **Paragraph A15**

The 8<sup>th</sup> bullet on this list identifies misclassification between account balances as a consideration factor in evaluating misstatements as material, even if the misstatement is lower than the

materiality level for the financial statements as a whole. This bullet appears to contradict the guidance in paragraph A14, which suggests that misclassifications over the materiality level for the financial statements as a whole may not be evaluated as material. We recommend that the IAASB clarify the guidance related to the evaluation of misstatements related to misclassifications.

- **Paragraph A17**

We believe that the last sentence of the paragraph provides more confusion than clarity. Use of the present tense in drafting the sentence also makes it difficult to understand and apply. We recommend deleting the sentence.

- **Paragraph A25**

We are unsure how the factors listed in (a), (b) and (c) affect the “manner” in which the auditor documents his or her conclusion about whether uncorrected misstatements may cause the financial statements as a whole to be materially misstated. We believe that the guidance in paragraph 35 of the close-off draft of the proposed standard (noted below) is clearer and therefore recommend its use in the proposed standard instead of paragraph A25.

“35. **Misstatements are documented in a manner that allows the auditor to:**

**(a) Separately consider the effects of factual misstatements, judgmental misstatements and projected misstatements;**

**(b) Consider the aggregate effect of uncorrected misstatements on the financial statements as a whole;**

**(c) Evaluate whether the materiality level for a particular class of transactions account balance or disclosure, if any, has been exceeded; and**

**(d) Evaluate the effect of uncorrected misstatements on key ratios or trends, and compliance with legal, regulatory and contractual requirements (e.g., debt covenants).”**

We would be pleased to discuss our letter with you or your staff at your convenience. If you have any questions, please contact Jens Simonsen, Director of Global Audit Services at + 45 3610 3781 or John Fogarty, Chairman - DTT Assurance Technical Policies and Methodologies Group at + 1 203 761 3227.

Very truly yours,

