May 17, 2005

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

Exposure Draft, Proposed International Standard on Auditing (ISA) 320 (Revised), 
Materiality in the Identification and Evaluation of Misstatements

Dear Mr. Sylph:

The American Institute of Certified Public Accountants (the AICPA) is pleased to comment on the above referenced exposure draft, Proposed International Standard on Auditing (ISA) 320 (Revised), Materiality in the Identification and Evaluation of Misstatements. We believe that this draft provides much-needed guidance to auditors in the areas of audit risk and materiality; however, we have a number of concerns about the proposed ISA that we believe require attention before a final Standard is issued.

General

We believe that the concepts of audit risk and materiality are closely related. Extant ISA 320, Audit Materiality, (paragraphs 8 through 11) provides a plain English explanation of this relationship, but it appears that this explanation is not reflected in the Proposed ISA. We recommend that the proposed ISA carry over an explanation of the relationship of audit risk and materiality in the introduction section to ensure that auditors fully understand this important concept and its relationship to the audit.

Materiality in the Context of an Audit

The section entitled Materiality in the Context of an Audit attempts to create a bridge between the accounting definition of materiality, as defined in International Accounting Standard (IAS) No. 1, Presentation of Financial Statements and the auditor’s perspective.

In paragraph 6, materiality is defined as:

“Omissions or misstatements of items are material if they could, individually or collectively; influence the economic decisions of users taken on the basis of the
financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.”

In this definition, the use of the word *could* without a modifier such as *reasonably*, establishes a very low threshold of materiality in light of the fact that the word *could* implies a potentially endless number of possibilities. If the auditor is to design an audit to detect what *could* influence the economic decisions of users, this may impose an unreasonable and impractical instruction to the auditor, especially when dealing with the needs of users of general purpose financial statements.

We suggest that the following language be added to paragraph 6 to provide some context.

**The auditor’s consideration of materiality is a matter of professional judgment and is influenced by the auditor’s perception of the needs of reasonable users who may use the financial statements in making economic decisions. The perceived needs of users are recognized in the discussion on materiality in IAS No. 1, which defines materiality in the following terms from the perspective of preparers of financial statements:**

“Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.”

**That discussion recognizes that materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations.**

In addition, the definition of materiality, as set forth in paragraph 6, is not consistently interpreted within the proposed standard. In attempting to bridge from the preparer’s perspective of materiality to the auditor’s perspective of materiality, paragraph 8 states that the determination of materiality, therefore, takes into account how users … could reasonably be expected to be influenced in making economic decisions. We believe use of the word reasonably in this context is appropriate, but that does not resolve the inconsistency.

**Use of Percentage of Benchmarks**

We support the inclusion of illustrative benchmarks in paragraph 13 of the Proposed ISA. However, while the discussion is general, care should be taken to ensure that the guidance is not misleading either because of the omission of information or by providing incomplete
information. For example, there are entities that operate in significant industries such as banks, insurance and governmental that may use other benchmarks.

We suggest that the following sentence be inserted at the end of paragraph 13:

Other entities (e.g., banks, insurance, governmental entities) might use other benchmarks.

Paragraph 13 also states that an appropriate benchmark may be profit before tax from continuing operations. While this may be an appropriate base for purposes of determining planning materiality, caution should be given that in the evaluation of audit findings phase of the audit the effect of taxes on uncorrected misstatements identified during the audit, if any, should be considered in evaluating whether the financial statements are fairly stated.

While we believe that guidance about benchmarks in general terms is important, we are concerned that the inclusion of specific illustrative examples of percentages may be misinterpreted by auditors and may, in fact, be applied as a standard. We believe that it is more appropriate for this type of guidance to be included in a separate auditing guide and not in the text of the ISA. However, we understand that the IAASB does not currently have the time or resources to provide this guidance in another form. Thus, we support its inclusion in this proposed ISA.

Paragraph 14 provides a list of illustrative examples of percentages that may be applied to benchmarks set forth in paragraph 13. We believe that the percentages provided as examples in paragraph 14 are not representative examples for certain entities such as audits of private entities, financial institutions or governmental entities.

We suggest that the following additional bullet be included in paragraph 14:

• Audits of other entities might use a percentage of total assets or a percentage of total revenues.

Materiality for Particular Items of Lesser Amounts than the Materiality Level Determined for the Financial Statements as a Whole

Paragraph 19 suggests that obtaining an understanding of the views and expectations of those charged with governance, and of management, may help the auditor judge whether misstatements of particular items of lesser amounts than materiality for the financial statements as a whole could reasonably be considered material by the users of the financial statements.

We believe that it is appropriate to take the views and expectations of those charged with governance into account in determining materiality, but at the end of the day, materiality should be set at an amount that the auditor determines is appropriate in the engagement circumstances. The auditor should not adopt planning materiality levels less than his or
her own judgment would dictate, irrespective of the views and expectations of those charged with governance or management, but may use lesser levels based on a consideration of such views and expectations when they have been explicitly presented to the auditor.

We are concerned with the implications of this guidance as written. The views of those charged with governance in respect to qualitative materiality considerations may not necessarily be relevant to the objectives of an audit of the financial statements, albeit they may be legitimate concerns from a governance perspective. For example, expense reimbursement may be a concern of those charged with governance, and the auditor may be engaged by the entity to test these areas. However, expense reimbursements generally are not material to the financial statements and may not be tested as part of the financial statement audit.

**Tolerable Error**

Paragraph 20 establishes a requirement that the auditor determine one or more levels of tolerable error. However, the proposed ISA does not provide guidance on the application of tolerable error in designing substantive procedures to test classes of transactions, account balances and disclosures. Without some discussion and guidance on tolerable error and its relationship to materiality in planning, the auditor will not understand its importance in designing sufficient appropriate audit procedures. We would support the inclusion of guidance that illustrates the use of tolerable error.

We suggest the IAASB consider the following language for the section on tolerable error.

Xx Tolerable error is the maximum error in the population (e.g., the class of transactions or account balance) that the auditor is willing to accept.

Paragraphs 20 and 21 remain the same.

Xy In determining the tolerable error, the auditor adjusts -materiality for the financial statements as a whole for expected misstatements (uncorrected known and likely misstatements. Ordinarily, the auditor applies a percentage, usually between 50 percent and 75 percent, to materiality for the financial statements as a whole to determine tolerable error.

Xz The auditor uses tolerable error to determine individually significant items that are to be examined 100 percent, and to determine the sample size for additional items to be tested. In setting an amount for individually significant items, the auditor uses his or her judgment to determine whether an amount below tolerable error is used. The auditor might also identify unusual balances and transactions as individually significant items.

Footnote 3 should be deleted.
Communication of Misstatements to Management

Paragraph 28 states that auditors should accumulate all known and likely misstatements identified during the audit, other than those that the auditor believes are clearly trivial, and communicate them to the appropriate level of management on a timely basis. We agree with this requirement; however, the phrase “on a timely basis” is unclear and may be interpreted in many different ways. For example, does this requirement indicate the communication should be contemporaneous? We believe that illustrations of timely communications or more guidance on what is “timely” will be helpful in implementation.

Both paragraphs 28 and 32 refer to the term “clearly trivial.” Trivial means “of little worth or importance.” Clearly trivial, therefore would seem to mean, something that is clearly of little importance. Further footnote four introduces a new way of defining clearly trivial as something that is clearly inconsequential. Inconsequential is defined as “of no significance.” We believe that the use of “clearly” in relation to trivial or inconsequential is unnecessary. By definition, something is either trivial or it is not trivial.

We suggest that references to “clearly trivial” in paragraphs 28 and 32 be replaced with “trivial” and that the following language is used to define “trivial” in footnote four.

Matters that are “trivial” are amounts designated by the auditor below which misstatements need not be accumulated. This amount should be set so that any such misstatements, either individually or when aggregated with other such misstatements, would not be material to the financial statements, after the possibility of further undetected misstatements is considered.

Known versus Likely

Paragraph 31 of the Proposed ISA categorizes differences in estimates as known misstatements involving subjective decisions. Because the calculation of the auditor’s estimate is based on a sample or some other estimation technique, we believe that the difference between management’s estimate and the auditor’s estimate is more appropriately categorized as a likely misstatement, i.e. misstatements that the auditor considers likely to exist based on an extrapolation from audit evidence obtained.

Paragraph 74 of proposed ISA 540 Auditing Accounting Estimates and Related Disclosures (Other than Those Involving Fair Value Measurements and Disclosures), suggests that likely misstatements are misstatements the auditor considers likely to exist from an extrapolation from audit evidence, for example, the amount obtained by projecting known misstatements identified in an audit sample to the entire population from which the sample was drawn. Paragraph 69 of Proposed ISA 540 suggests that if the auditor is able to make a probability assessment concerning the likelihood of various outcomes within the
reasonable range being the actual outcome, the known misstatement involving subjective
decisions is the difference between management’s point estimate and the auditor’s point
estimate, regardless of whether management’s point estimate falls inside or outside the
auditor’s reasonable range of outcomes. We believe that paragraphs 69 and 74 of ISA 540
are inconsistent. A sample result is based on a probability assessment, so in our view the
nature of the misstatement arising from this process should be the same in either subjective
or objective (sample) estimation. We believe that it is inconsistent that a probability
assessment of a subjective estimate would result in a known misstatement, whereas a
probability assessment of an objective estimate would result in a likely misstatement.

Finally, we understand that Proposed ISA 540 needs to relate the concepts of estimates to
known and likely misstatements. However we suggest the guidance and clarification in
Proposed ISA 540 of what constitutes a known and likely misstatement and how these
amounts are treated in the aggregation process more rightfully (or also) belongs in
Proposed ISA 320, as we believe auditors are more likely to seek guidance on materiality
matters in this ISA. This involves the concepts in paragraphs 66-74 of the proposed ISA
540.

**Evaluating the Effect of Uncorrected Misstatements**

We support guidance that requires the auditor to evaluate, both individually and in the
aggregate, uncorrected material misstatements and does not waive any material
misstatements, including those related to prior periods.

We interpret paragraph 36 to require that the auditor, in evaluating the effect of
uncorrected misstatements, must consider uncorrected misstatements under the balance
sheet cumulative misstatement (iron curtain) method and the income statement, net of
rollover (rollover) method. We support an approach that requires the auditor to consider
and adjust misstatements under both the iron curtain and the rollover methods.

However, we believe the guidance, as written, in paragraph 36 lacks clarification and
specificity. We suggest clarification by an example of its application. Failure to clearly
illustrate this concept in the proposed ISA will result in differential application (or
misapplication) in practice.

To make the guidance clearer, we propose the following revision to paragraph 36:

36. Before considering the aggregate effect of identified uncorrected
misstatements, the auditor considers each misstatement separately **to evaluate:**

   (c) **To evaluate** The effect of misstatements related to prior periods.

   In prior periods, misstatements may not have been corrected by the entity because they did not cause the financial statements for those
periods to be materially misstated. Those misstatements might also affect the current period's financial statements.¹

xx. In aggregating misstatements, the auditor should include the effect on the current period's financial statements of those prior period misstatements. In doing this, the auditor should consider the cumulative uncorrected misstatements that apply to the balance sheet, including misstatements arising in the current period, on the current period financial statements, and propose any necessary adjustments to reduce the amount of uncorrected misstatements to less than materiality.¹

FN 1- The materiality used for this assessment should be relevant to the final financial statements, which may differ from planning materiality. Some entities base this assessment of materiality on income, and other entities (e.g., private entities, financial institutions or government entities) use other relevant bases of measurement. The auditor uses the same materiality base for these comparisons as he or she used in planning the engagement, updated to reflect period-end financial information.

FN 2 - Some misstatements, such as inventory misstatements, may give rise to overstatements in one period and understatements in a later period. In this circumstance, the auditor considers the rollover effect of the misstatements on current period income and also considers the period end uncorrected misstatement in the inventory account when assessing whether an adjustment is required.

We would also support the use of a more concrete illustrative example. The inconsistency in terminology and practice in this area warrants careful attention to the issue in setting standards. We suggest the following:

For example, if inventories were overstated at the beginning of the year by $50,000 and overstated by $75,000 at year end, the balance sheet misstatement is $75,000 and the net rollover effect on income for the year is $25,000 ($75,000 - $50,000). Since the balance sheet impact

¹ The measurement of the effect, if any, on the current period's financial statements of misstatements uncorrected in prior periods involves accounting considerations and is therefore not addressed in this section.
is greater, the auditor would consider adjusting the $75,000 to reduce the unadjusted misstatement below materiality. If, in another case, opening inventory is overstated by $50,000 at the beginning of the year, but understated by $75,000 at the end of the year, the income effect of the misstatements would be $125,000 ($50,000 + $75,000). The $125,000 would be compared to materiality to determine if an adjustment is required. An adjustment of $75,000 (the balance sheet misstatement) could be proposed to reduce the misstatement below materiality.

Evaluating Whether the Financial Statements as a Whole are Free of Material Misstatement

Paragraph 35 establishes a bold letter requirement that the auditor evaluate whether uncorrected misstatements identified during the audit are material, either individually or in the aggregate. The auditor is required to 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 the engagement.

Paragraph 40, which provides the guidance on how to interpret and apply the requirement in paragraph 35, introduces a new concept, that of “possible bias in management’s judgments” and a “lack of neutrality” that the auditor takes into account when evaluating whether the financial statements as a whole are free of material misstatement. The requirement in paragraph 35 relates to uncorrected misstatements identified during the audit. The proposed ISA now introduces the concept of possible management bias and lack of neutrality. While we support the merits of the auditor standing back and evaluating whether the financial statements as a whole are free of material misstatement, the concept possible management bias and lack of neutrality should be supported with guidance on its application in practice, for example, what does the auditor do if he or she identifies indicators of bias? We note that proposed ISA 320 and proposed ISA 540, *Auditing Accounting Estimates and Related Disclosures (Other than Those Involving Fair Value Measurements and Disclosures)* both introduce the concept of potential management bias. However, neither document concludes as to whether possible management bias is or is not a misstatement. Instead, both documents point to each other. As written, we believe that the concept of the auditor’s consideration of possible management bias will not be fully understood by auditors and thus will not be implemented consistently. If indicators of management bias are present, the auditor should undertake sufficient audit procedures to be satisfied that the accounting estimates are neutral and thus free of bias. The auditor uses a neutral estimate for purposes of assessing the reasonableness of management’s estimates and differences, if any, are evaluated as uncorrected misstatements.
Documentation

We recommend that the proposed ISA more explicitly explain the term “levels of materiality and tolerable error, including any changes thereto” so that auditors more fully understand the terms and be able to satisfy the documentation requirements of paragraph 45.

Paragraph 11 of the proposed ISA requires that the auditor develop levels of materiality for the purpose of establishing the overall strategy of the audit, or succinctly stated, “planning materiality.” As the audit progresses, the auditor should reassess the planning materiality determined in order to update it for period end financial information (failure to do so may result in inadequate or insufficient audit procedures). In addition, as suggested in paragraph 37, there are circumstances related to some misstatements that may cause the auditor to evaluate them even though they are lower than materiality (qualitative considerations).

As a result of the auditor’s reassessment of materiality and qualitative considerations, there may be instances in which the levels of materiality used for planning purposes will differ from the levels of materiality ultimately used by the auditor for evaluative purposes. This is clearly the inference in paragraph 45 (c) because in order for the auditor to document his or her conclusion as to whether uncorrected misstatements are material to the financial statements, and the basis for that conclusion, the auditor must use levels of materials relevant to the period-end financial statements and qualitative measurements.

We believe that the auditor should document the levels of materiality and tolerable errors determined in establishing the overall strategy for audit (“planning materiality”) as well as the levels of materiality used to evaluate the effect of uncorrected misstatements. In addition, the auditor should document his or her reassessment of planning materiality and the qualitative measures considered in evaluating the effect of uncorrected misstatements.

*****

Thank you for the opportunity to comment on this exposure draft. If you have any questions regarding the comments in this letter, please contact either Sharon Walker at (212) 596-6026, swalker@aicpa.org or Hiram Hasty at (212) 596 6011, hhasty@aicpa.org.

Respectfully submitted,

William F. Messier
Chair, International Auditing Standards Subcommittee

9