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Mr. James Sylph
Technical Director
International Auditing and Assurance Standards Board
545 Fifth Avenue, 14th Floor
New York, New York 10017

Via email – Edcomments@ifac.org

Dear Mr. Sylph:

Grant Thornton International appreciates the opportunity to comment on the Proposed International Standard on Auditing (ISA) 320 (Revised), *Materiality in the Identification and Evaluation of Misstatements*, approved for publication by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC).

We support the IAASB's issuance of the proposed revised standard, which significantly improves existing standards with regard to the determination of materiality and the identification, evaluation, and communication of misstatements. The revision is necessary in order to converge national standards and to promote the acceptance of international standards by regulators, legislators and the profession. Nevertheless, we have a number of comments that we believe will improve the quality, clarity, and effectiveness of the proposal. Accordingly, we respectfully submit our comments and recommendations below and in the attached Appendix.

## Tolerable Error

We commend the IAASB for introducing the concept of tolerable error in the proposed revised standard. However, the requirement to determine tolerable error and the guidance allocated to this important topic are deficient in that they do not adequately describe the importance of tolerable error to the performance of further audit procedures and its relationship to materiality.

Tolerable error is derived from, and normally is smaller than, the materiality level for the financial statements as a whole. It is an estimate of the maximum acceptable amount of misstatement of an individual account balance (or group of related accounts, such as raw materials inventory), a class of transactions, or disclosure. It represents the largest possible misstatement in an account balance, class of transactions, or disclosure that, when aggregated with possible misstatements in other account balances, classes of transactions, or disclosures, would not create an unacceptable risk of material misstatement of the financial statements. Tolerable error is established to coordinate the scopes of the various further audit procedures so they provide reasonable assurance that a material misstatement, if it exists, will be detected. That is, the auditor designs each test of an account balance, class of transactions, or disclosure to search for misstatements that, in the aggregate, exceed tolerable error. Tolerable error is a quantitative measure that (a) relates to the materiality level for the financial statements as a whole, (b) reflects the magnitude of expected error in the financial statements, and (c) provides an allowance for potential error that may remain undetected.

As tolerable error drives the extent of further audit procedures to respond to the assessed risks of material misstatement, it is critical that the IAASB incorporate the concepts discussed above in the final standard. In addition, the IAASB should consider including illustrative examples that might be applied when computing tolerable error. For example, tolerable error may be calculated as a percentage of materiality taking into consideration the expected error. As the expected error increases, tolerable error decreases and therefore, causes the scope and the extent of audit procedures to increase.

## Materiality for Particular Items

The proposed revised standard requires the auditor to consider, when establishing the overall strategy for the audit, lower materiality levels than the materiality level determined for the financial statements as a whole for particular items in the financial statements. We believe that this requirement challenges the overall objective of an audit and the concept of audit risk.

An audit is designed to provide reasonable assurance that the financial statements <u>taken as a whole</u> are free from material misstatement. This is apparent in paragraph 17 of ISA 200, *Objective and General Principles Governing an Audit of Financial Statements*, which states "The auditor is concerned with material misstatements, and is not responsible for the detection of misstatements that are not material to the financial statements taken as a whole." Therefore, the auditor plans and performs the audit to reduce audit risk to an acceptably low level that is consistent with the objective of an audit. Accordingly, depending on the nature of the entity and the industry in which it operates, the materiality level for the financial statements as a whole is ordinarily determined based on the smallest aggregate level of misstatements that could be considered material to any one of the financial statements. Such materiality is then used to calculate tolerable error, which, as mentioned previously, drives the extent of further audit procedures to respond to the assessed risks of material misstatement.

To introduce the concept of a quantitative lower level of materiality for particular items in the financial statements indirectly implies that the auditor provides a higher level of assurance for such items over and above the reasonable assurance that is required to opine on the financial statements as a whole. The auditor does not provide specific assurance on a particular account balance, class of transactions, or disclosure. Although we understand that certain items in the financial statements are qualitatively material and therefore, may influence the users of such statements, we believe that this is taken into consideration when performing the risk assessment and further audit procedures and when evaluating identified misstatements on a quantitative, as well as qualitative, basis.

Therefore, the requirements and guidance provided by paragraphs 17-19 should be rewritten to describe how particular items of lesser amounts than the materiality level determined for the financial statements as a whole may be considered qualitatively (versus quantitatively) material to the financial statements and how such items should be addressed with regard to the risk assessment standards and the newly introduced concept of tolerable error. It should be noted that the auditor is alert for misstatements that could be qualitatively material, but that it is ordinarily not practical to design further audit procedures to detect them. As indicated previously, tolerable error is a quantitative measure and therefore, cannot be used to design procedures to detect misstatements that are qualitatively material. The IAASB should also reconsider the examples provided by paragraph 18; more specifically, how such examples may (a) contribute to the auditor's determination of the materiality level for the financial statements as a whole, (b) influence the auditor's risk assessment and further audit procedures, and (c) relate to the qualitative factors discussed in paragraph 37.

## Evaluating the Financial Statements as a Whole

In paragraph 39, the proposed revised standard requires the auditor to evaluate whether the financial statements as a whole are free from material misstatement by considering the uncorrected misstatements and the qualitative aspects of the entity's accounting practices. Such evaluation appears to be in addition to the obligation in paragraph 35, which requires the auditor to evaluate the effect of uncorrected misstatements, individually and in the aggregate. We believe that the separate evaluation required by paragraph 39 is (a) incorporated into the risk assessment and further audit procedures, (b) part of the evaluation of uncorrected misstatements required by paragraph 35, and (c) included in the auditor's final analytical procedures.

The auditor plans and performs the audit to obtain reasonable assurance that the financial statements taken as a whole are free from material misstatement. Misstatements may consist of, among other things, unreasonable accounting estimates or the inappropriate selection of accounting practices. Such uncorrected misstatements are evaluated to determine whether they are material, individually or in the aggregate, to the financial statements taken as a whole. The selective correction of misstatements and management bias in making accounting estimates are qualitative factors that are considered when evaluating the materiality of uncorrected misstatements. For example, the auditor considers whether not correcting a misstatement that decreases earnings may affect management compensation or any of the other qualitative factors listed in paragraph 37. The same applies with regard to identified misstatements pertaining to estimates.

Regardless of the type of misstatement, the auditor's ultimate responsibility is to opine whether the financial statements give a true and fair view (or are presented fairly, in all material respects) in accordance with the applicable financial reporting framework, which ordinarily includes the relevance and reliability of such statements. Reliability includes matters such as representational faithfulness, verifiability, and neutrality (i.e., free from bias). The procedures performed throughout the audit, including the quantitative and qualitative evaluation of uncorrected identified misstatements, provide the auditor with reasonable assurance as to whether the financial statements are free from material misstatement, including whether such financial statements are free from bias.

Thus, a separate evaluation of the uncorrected misstatements and the qualitative aspects of the entity's accounting practices at the end of the engagement, as required by paragraph 39, is not necessary. Such matters should be discussed in the context of planning and performing the audit and in forming the final opinion, including the analytical procedures performed at or near the end of the engagement, which corroborate the auditor's conclusions with regard to individual components or elements of the financial statements and assist in arriving at an overall conclusion as to the reasonableness of the financial statements as a whole. However, the auditor should communicate matters relating to the quality of an entity's financial reporting that come to the auditor's attention during the audit to those charged with governance. This would include communicating matters such as the consistent application of accounting policies, the clarity and completeness of the financial statements, and other items that significantly impact the accounting information in the financial statements (e.g., representational faithfulness, verifiability, and neutrality).

## Evaluating the Effect of Uncorrected Misstatements

When evaluating the effect of uncorrected misstatements, the auditor evaluates, among other things, the effect of misstatements related to prior periods (as prescribed by paragraph 36). Such misstatements pose additional considerations.

The two most common methods used to evaluate misstatements are referred to as the "iron curtain" and the "rollover" method. The iron curtain method assesses the gross effect of uncorrected misstatements as of the balance sheet date. The rollover method focuses more on the income statement because it considers the reversing effect of prior period misstatements. For instance, if a company increases a reserve by $10 more than necessary each year for three years, the rollover method treats the error as being $10 in each year, while the iron curtain method treats the error as $10 in the first year, $20 in the second, and $30 in the third year.

Some believe that a weakness of the rollover method is the potential for the accumulation of uncorrected misstatements on the balance sheet over multiple periods. Others are concerned that the iron curtain method disregards the effect of recording misstatements from prior periods on the current period income statement.

Diversity exists in current practice, in part, because neither auditing nor accounting standards address this issue. In order to serve the public interest, we encourage IFAC and the IAASB to provide leadership in this area by communicating their position with regard to the use of iron curtain versus rollover to the International Accounting Standards Board.

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We would be pleased to discuss this letter with you or another member of the IAASB staff. Please contact me at (732) 516-5550, if you have any questions.

Very truly yours,

Grant Thornton International
Barry Barber
Worldwide Director of Audit and Quality Control

## APPENDIX

The following offers additional general and paragraph-level comments for your consideration. It also includes our responses to the IAASB's questions with regard to public sector entities, small entities, and translations. Suggested new language is shown in boldface; suggested deleted language is shown by strikethrough.

- **Paragraph 3(c)** – We recommend clarifying that the auditor considers materiality when evaluating the effect of identified uncorrected misstatements on the financial statements. Such evaluation then assists the auditor in determining the impact of uncorrected misstatements on the auditor's report. Accordingly, we propose the following revision:

  "When evaluating the effect of identified uncorrected misstatements on the **financial statements and the** auditor's report **thereon**."

- **Paragraph 4(e)** – This paragraph states that misstatements can arise from error or fraud and may consist of, among other things, "differences between management's and the auditor's judgments concerning accounting estimates or the selection and application of accounting policies that the auditor considers inappropriate." We do not believe that misstatements arise from differences between management's and the auditor's judgments. As management is responsible for the financial statements, such misstatements arise from inappropriate management judgments that lead to unreasonable accounting estimates or the inappropriate selection or application of accounting policies. As such, we recommend replacing paragraph 4(e) with the following:

  Misstatements can arise from error or fraud and may consist of … "**Management's judgments concerning an accounting estimate or the selection or application of accounting policies that the auditor considers unreasonable or inappropriate**."

- **Paragraph 8(b)** – This paragraph appears to imply that users (or preparers) can choose a more or less expensive audit by requesting a lower or higher materiality level. Although an inverse relationship exists between materiality and the cost and timing of an audit (i.e., increases in materiality decrease cost and timing), materiality is a factor of the financial statements and is determined by the auditor. Users should, however, understand that there is a cost of obtaining evidence and that an audit does not provide assurance that the financial statements are free of all misstatements. Accordingly, we suggest the following revision:

  "**For the purpose of the audit, u**~~U~~sers are assumed to … Understand that **there is a rational relationship between the cost of obtaining evidence and the usefulness of the information obtained; therefore,** financial statements are prepared and audited to levels of materiality and ~~that~~ **an audit does not provide assurance that the financial statements are free of all misstatements**~~there is a relationship between the level of materiality and the cost and timing of the audit~~."

- **Paragraph 10** – We suggest deleting this paragraph or enhancing the guidance pertaining to specific users. The proposed revised standard already requires the auditor to consider the needs of users. However, we note that specific users may have a wide range of needs and all special-purpose audits may not be performed for a narrow range of users. Also, the comma after "information" in the second line should be removed.

- **Paragraph 12 –** We recommend the following revision for the reasons discussed in our comment pertaining to paragraph 3(c) above:

"This materiality level does not, however, establish a threshold below which identified misstatements are always considered to be immaterial even when evaluating those misstatements and their effect on the **financial statements and the** auditor's report **thereon**."

- **Paragraph 13** – We suggest that the IAASB expand the factors the auditor considers when identifying the appropriate benchmark to contemplate a base that is relatively stable, predictable, and representative of the entity's size. We further suggest the following revision:

  "For asset based entities (e.g., an investment fund**, bank, or other financial institution**) an appropriate benchmark might be net assets."

- **Paragraph 14** – This paragraph provides illustrative examples of percentages of benchmarks that might be considered by the auditor. Such examples are useful, as they may guide the auditor's judgments with regard to extreme variances. However, although the explanatory memorandum stipulates that such percentages are not meant to be formulaic and the proposed revised standard itself states that higher or lower percentages may be appropriate, we prefer that additional language be added to further clarify this point. For example, the following revisions may be appropriate:

  "**These percentages are provided for the purpose of providing illustrative examples and are not required to be applied by the auditor. Accordingly, t**~~T~~he auditor may consider higher or lower percentages than those illustrated above to be appropriate. **National standards or practices may provide other examples or be more prescriptive.**"

- **Paragraph 15** – We suggest that the IAASB further address materiality in an audit of less than a twelve-month period. The following is a passage from standards established by the Canadian Institute of Chartered Accountants: "A fiscal year is normally a twelve-month period, but in some circumstances, such as for a new entity or a change in fiscal year end, may be more or less than twelve months. In circumstances such as those described, the auditor would determine materiality in relation to the financial statements on which he or she is reporting."

  Further, the IAASB should consider providing additional guidance on determining materiality by (a) excluding unusually large or non-recurring items, and (b) using materiality percentages represented by a sliding scale in which the percentage decreases as the size of the entity increases (i.e., as the size of the entity doubles, materiality increases but may not double in amount).

- **Paragraph 16** – The use of the term "higher" in this paragraph may be misinterpreted. We believe that the notion of this paragraph is that estimation uncertainty affects risk, not materiality, and that the materiality level for similar entities should not significantly differ, regardless of whether or not the financial statements include a high degree of estimation uncertainty. As such, we propose the following revision:

  "For example, the fact that the financial statements include very large provisions with a high degree of estimation uncertainty … does not cause the auditor to determine the materiality level for the financial statements to be **significantly different** ~~higher~~ than for financial statements that do not include such inherent estimation uncertainty."

- **Paragraphs 25 and 26** – The IAASB should reconsider the term "need to" and how it differs from the "should" imperative. In addition, in paragraph 26, we suggest adding a reference to paragraph 34 of ISA 330, *The Auditor's Procedures in Response to Assessed Risks*, which discusses how material misstatements detected by the auditor's procedures ordinarily are indicative of the existence of a material weakness in internal control.

- **Paragraph 27** – We agree with the requirement for the auditor to consider whether there is a greater than acceptable low level of risk that undetected misstatements, when taken with the aggregate of identified misstatements, could exceed materiality. However, such evaluation should be performed with regard to identified uncorrected misstatements, in addition to performing the evaluation on a continuous basis throughout the audit. Accordingly, as paragraphs 25 and 26 establish the requirements for considering identified misstatements throughout the audit, we recommend (a) moving paragraph 27 to the section entitled "Evaluating the Effect of Uncorrected Misstatements" and (b) clarifying that this evaluation is performed with regard to identified (accumulated) uncorrected misstatements, in lieu of all identified misstatements that would include those corrected by management and those misstatements that are deemed clearly trivial.

- **Paragraph 29** – We recommend (a) adding clarifying language to define the "appropriate level of management," and (b) clarifying management's actions with regard to the auditor's communication of identified misstatements, as follows (see our comment pertaining to paragraph 34):

  "**Ordinarily, the appropriate level of management is the level that has responsibility and authority to evaluate the identified misstatements and to take action as necessary. Accordingly, t**~~T~~imely communication of misstatements to the appropriate level of management is important ~~as it enables management to evaluate whether the items are misstatements, or to inform the auditor if they disagree, and to take action as necessary.~~ **for management to determine whether the items identified are misstatements and either correct them or inform the auditor that they disagree. Management may determine that they will correct identified misstatements that they deem to be immaterial in the subsequent period.**"

- **Paragraph 31** – This paragraph introduces the definitions of known and likely misstatements. We believe that such definitions should be discussed earlier within the proposed revised standard and therefore, recommend that they be moved to the section entitled "Nature and Causes of Misstatements." Paragraph 31 could then simply state: "**When communicating details of misstatements, the auditor distinguishes between known misstatements, separately identifying misstatements of fact and misstatements involving subjective decisions, and likely misstatements, as defined in paragraph XX.**"

  In addition, for the reasons discussed in our comment pertaining to paragraph 4(e) above, we prefer that the definition of misstatements involving subjective decisions read as follows: "**These arise from management's judgments concerning an accounting estimate or the selection or application of accounting policies that the auditor considers unreasonable or inappropriate.**"

- **Paragraph 34** – We share the IAASB's views, as expressed in the Explanatory Memorandum, with regard to promoting "…an environment in which the correction of misstatements is seen as the appropriate course of action, regardless of whether they are evaluated as material or not." As such, we believe that this paragraph does not adequately stress the importance of correcting immaterial misstatements (other than those that are clearly trivial). Therefore, we urge the IAASB to strengthen the language therein by communicating the need to correct such misstatements, which may entail explaining how uncorrected misstatements could potentially cause future financial statements to be materially misstated.

  Further, we suggest adding a reference to ISA 580, *Management Representations*, which requires the auditor to obtain written representations from management with regard to uncorrected misstatements. We also recommend that the IAASB consider amending ISA 580 to require the auditor to obtain an additional representation from management that the misstatements proposed by the auditor have been approved by management and will be recorded on the books and records of the entity.

- **Paragraph 35** – This paragraph requires the auditor to evaluate whether identified uncorrected misstatements are material, individually or in the aggregate. Although we believe that such evaluation would not include those misstatements that are clearly trivial, we recommend the following revision to clarify that the evaluation is based on identified, accumulated uncorrected misstatements (as the concept of accumulation is discussed in paragraph 28):

  "The auditor should evaluate whether uncorrected misstatements that have been ~~identified~~ **accumulated** during the audit are material, individually or in aggregate."

- **Paragraphs 35 & 37** – An auditor should evaluate identified misstatements on a quantitative and qualitative basis. Paragraph 37 describes certain circumstances that the auditor considers when evaluating whether misstatements are qualitatively material. To ensure clarity and consistent application with regard to evaluating the materiality of identified misstatements, we suggest revising (a) paragraph 35 to specifically require the auditor to evaluate whether misstatements are quantitatively or qualitatively material, and (b) paragraph 37 to clarify that the circumstances listed are qualitative considerations.

- **Paragraph 36(b)** – We suggest deleting this paragraph. As misstatements are evaluated individually, as well as in the aggregate, we believe that it is inappropriate to imply or allow the offset of misstatements, especially as uncorrected misstatements could potentially cause future financial statements to be materially misstated.

- **Paragraph 45** – We believe that the auditor should document all misstatements that he or she identified, regardless of whether or not they have been corrected by management. Accordingly, we suggest that the auditor also document:

  "**All known and likely misstatements identified by the auditor during the audit, other than those that are clearly trivial, that have been corrected by management.**"

- **Paragraph 45(a)** – This paragraph requires the auditor to document the levels of materiality and tolerable error, including any changes thereto, and the basis on which those levels were determined. We believe that this requirement may become quite onerous, as facts and circumstances always arise where the auditor may choose to do more work. In conjunction with our comment on "Clarity" below, we believe that the auditor should, alternatively, document planning materiality, tolerable error determined for planning purposes, and evaluative materiality, including the basis on which those levels were determined.

- **Paragraph 46** – We suggest clarifying that this paragraph pertains to "uncorrected" misstatements.

- **Clarity** – Consistent with the Proposed Policy Statement, *Clarifying Professional Requirements in International Standards Issued by the IAASB*, the use of the present tense should be eliminated. In addition, the IAASB should consider the use of the terms "planning materiality" and "evaluative materiality." Although we acknowledge that "planning" is not a phase in and of itself and that the materiality level for the financial statements as a whole is continually evaluated, we believe that using such terms would contribute to the clarity and consistent application of the final standard.

- **Public Sector** – The proposed revised standard is suitable and can be adapted for public sector entities. However, the incremental considerations prepared by the Public Sector Committee can be enhanced. For example, the Public Sector Committee may consider whether it is necessary to provide additional guidance with regard to the types of benchmarks that might be used for such entities (e.g., expenditure budget). In addition, it may be appropriate to state that auditors may need to set lower materiality levels than in audits in the private sector because of public accountability, various legal and regulatory requirements, and the visibility and sensitivity of public sector programs.

- **Small Entities** – We believe that the guidance in the proposed revised standard can be applied equally well to entities of all sizes. The determination of materiality, including the evaluation of identified misstatements, is based upon what is material to the user. The size and nature of the entity are considered in determining the appropriate benchmark, as appropriately prescribed by the proposed revised standard.

- **Translation** – As we have not attempted to translate this document, we are not aware of any specific translation issues. We do, however, recommend the IAASB consider whether it is necessary to clarify and refine complex concepts and/or sentence construction.