Organización Internacional de Comisiones de Valores
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April 29, 2005

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

Re: Exposure Draft: Materiality in the Identification and Evaluation of Misstatements

Dear Mr. Sylph,

IOSCO's Standing Committee No. 1 on Multinational Disclosure and Accounting appreciates the opportunity to comment on the Exposure Draft (ED), "Materiality in the Identification and Evaluation of Misstatements". As securities regulators representing the public interest, we are committed to enhancing the integrity of international markets through promotion of high quality accounting, auditing, and professional standards. Our comments herein reflect those matters on which we have achieved a consensus among members of Standing Committee No. 1 and are not intended to include all the comments that might be provided by individual members on behalf of their respective jurisdictions in the future.

Overall, we welcome the greater rigor this ED introduces in defining and determining materiality in the context of the audit.

In particular we support:

- The emphasis on the consideration of materiality as judged by the impact of an error or omission on user decisions and also on the importance of context, i.e. making clear that materiality 'depends on the size and nature of an item or omission judged in the surrounding circumstances. The size or nature of an item, or a combination of both, could be the determining factor.' (paragraph 6);
- The emphasis that a high degree of inherent uncertainty does not necessarily mean that the materiality levels should be higher (paragraph 16);
- The emphasis on reassessing materiality as the audit progresses (paragraphs 22-27); and
- The need to evaluate the 'qualitative aspects of the entity's accounting practices' (paragraphs 39-41).

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However there are some aspects of the ED where we believe further improvements are needed. These are as follows:

- The discussion regarding consideration of the characteristics of users as described in paragraph 8 contains unnecessary criteria for assumptions about users and we are particularly concerned with the link in 8(b) to the level of materiality and the cost of the audit;

- The emphasis on the qualitative aspects of materiality;

- further explanation on materiality judgments made in planning and adjusting audit work (what you will look at and how) and materiality judgments made when a misstatement or potential misstatement is discovered and there is additional context to consider regarding whether the incorrect or omitted item would be expected to affect a user's decision;

- the discussion on quantitative measures of materiality;

- The need to explain in more detail the term "tolerable error" and its application in audit work

- The need for additional coverage of the evaluation of qualitative aspects of the entity's accounting practices; and

Also, given the importance and broad nature of the subject of materiality, we would have expected that enhancing the coverage in this ED would also result in conforming amendments to a number of other standards. Our more detailed comments on each of these aspects are as follows.

Materiality in the context of an audit and the role of users

We welcome the emphasis on materiality in the audit as omissions or misstatements that could influence the economic decisions of users. However, we believe that the criteria in paragraph 8, particularly criteria (a), (b) and (c) do not assist auditors make appropriate judgements about materiality for the audit. The characteristics presented set up expectations concerning the nature of users that would seem to be an attempt by auditors to 'risk manage' expectations of the objective of an audit and the nature of reasonable assurance. However, the objectives of an audit and the concept of reasonable assurance, as well as the assumption of a wide range of users, are already dealt with in ISA 200 and other standards. We would therefore recommend that paragraph 8 be omitted from the ED. Auditors need to evaluate materiality in the context of the financial statements and the guidance provided in the relevant financial reporting framework, including applicable law and regulation, or in IFRS if the relevant framework has no guidance.

Qualitative aspects of materiality

Though we appreciate the emphasis in the definition of materiality on the nature as well as the size of an item in considering materiality, we do not see this emphasis on the nature of an item (the qualitative aspects of materiality) carried through into the rest of the ED. Indeed there seems to be a disproportionate emphasis on the quantitative aspects of materiality e.g. the inclusion of a discussion on the use of percentages of benchmarks under paragraphs 13-15. We would strongly encourage the IAASB to provide more emphasis in the ED on the qualitative aspects of materiality. Paragraph 37 provides very good examples of qualitative aspects of materiality that could be given more emphasis if they were discussed earlier in the ED.

We also observe that paragraph 13 states, *'The determination of what is material to the users is a matter of professional judgement.'* We would suggest that this should be reworded to read: 'The determination of what is material to the users requires the exercise of professional judgement'. In addition, the same paragraph notes that *'The auditor often applies a percentage to a chosen benchmark as a step in determining materiality…'*. We suggest that there should be a comment included here that, 'applying a percentage is only one of the steps in determining materiality'. We believe these suggestions would add clarity to the paragraph.

Planning and evaluation materiality

There does not seem to be adequate explanation of the distinction between 'setting materiality levels for audit planning purposes' and 'reconsidering this planning materiality as the audit progresses', and 'considering the materiality of individual misstatements or omissions as the audit is conducted and such items are discovered'. We believe it would be useful and clearer to describe what might be termed "planning materiality" versus "evaluation materiality" or to otherwise describe how the judgments of materiality are made in those different circumstances

Quantitative measures of materiality

Paragraph14 of the ED provides some quantitative examples, such as five percent of profit before tax from continuing operations, or one half of one percent of total revenues. We understand these percentages are, in practice, used by some to judge materiality for companies which constantly generate profits. However we also understand that materiality levels may differ by situation, depend on the industry and many other factors. Indeed we question why these three specific examples are provided when there are many more examples that could be provided. Some of our members are concerned that inclusion of examples of percentages in the ED could sometimes lead to misunderstanding or misuse. In particular, we wonder whether showing such percentages could lead management to assume that such percentages are a "cap of allowable errors" that a company can bear. Therefore we request that paragraph 14 of the ED be revised to emphasize more fully that quantitative measures are only one consideration in assessing materiality, and that errors and omissions must always be considered in the context of how they might affect user decisions.

Tolerable error

The discussion of "tolerable error" in paragraphs 20 and 21 is very brief and does not explain to a great extent the principles involved, nor describe its application beyond the definition already included in the glossary. If this term is to be included in the ED, it should be explained more fully e.g. what happens to the definition of the level of tolerable error if the auditor finds many errors in his/her audit of transactions, account balances and disclosures.

Qualitative aspects of the entity's accounting practices

We welcome the inclusion of this aspect in the ED, but do not feel that the discussion of the subject, as currently presented, is as robust and comprehensive as is necessary to ensure that auditors consider and assess the relevant factors in this area of the audit. We are concerned both about the relatively brief coverage of the subject in this ED and the apparent lack of coverage in other ISAs, since no cross references are listed and we can find mostly brief mentions, not comprehensive guidance, in other ISAs. What should an auditor consider in evaluating the qualitative aspects of an entity's accounting policies? We believe that more is needed on this subject to provide guidance to the auditor

With regard to this ED, 'possible bias in management's judgement' is currently covered in paragraph 40 of the ED. As it could be an important aspect of considerations of determining planning materiality, would it not make more sense also to include a reference to this possibility at the planning stage when considering what might be material? An additional paragraph could be inserted between paragraphs 15 & 16 covering this area. For example, if there had been evidence in the previous year's experience of 'possible bias in management's judgement', the auditor might want to consider this factor as part of determining materiality for the audit at the planning stage.

With regard to other ISAs, we believe 'possible bias in management's judgement' needs to be more fully developed to ensure that the auditor is clearly guided in the ISAs on how to obtain sufficient and appropriate audit evidence concerning 'qualitative aspects of an entity's accounting practices'. For example, we would expect additional coverage in ISA 315 - *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* and a cross reference in this ISA. In ISA 315 there could be more background on when there might be indicators of issues with qualitative aspects of an entity's accounting practices and therefore the risk of material misstatement from this aspect, e.g. if there is pressure on management to deliver a specific level of earnings, and other possible indicators as described in ISA 240, *The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements*.

Conforming amendments

No conforming amendments to other ISAs have been published with this ED. We observe that this seems a little unusual as in this ED the concept of materiality has been further developed and explained. We request that the Board consider whether there should be any conforming amendments to other ISAs e.g. ISA 300, *Planning an Audit of Financial Statements.*

This concludes our comments. Thank you for the opportunity to comment on this ED. If you have questions regarding any of our comments, please do not hesitate to contact me or Susan Koski-Grafer at (202) 942-4400.

Sincerely,

Scott Taub

Scott Taub
Chairman
IOSCO Standing Committee No. 1