



G A O

Accountability \* Integrity \* Reliability

Comptroller General  
of the United States

United States Government Accountability Office  
Washington, DC 20548

May 2, 2005

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

Subject: *Proposed Revisions to International Standard on Auditing No. 320-  
Materiality in the Identification and Evaluation of Misstatements*

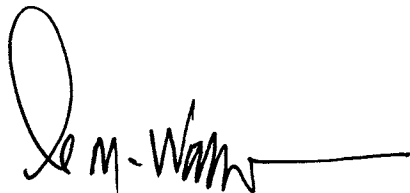
This letter provides the U.S. Government Accountability Office's (GAO) comments on the International Auditing and Assurance Standards Board (IAASB) December 2004, proposed revisions to International Standard on Auditing (ISA) No. 320 - *Materiality in the Identification and Evaluation of Misstatements*.

GAO actively coordinates with accountability organizations around the world, and actively participates in the International Organization of Supreme Audit Institutions (INTOSAI), the professional organization of the national audit offices of 184 countries. Through our international work, we strive to strengthen professional standards, promote best practices, provide technical assistance, leverage resources, and develop strategic working relationships that allow us to extend our institutional knowledge and experience around the world.

We commend the IAASB for its work to establish high quality auditing and assurance standards and to improve the uniformity of practice by professional accountants throughout the world. Overall, we support the IAASB's proposed revisions to ISA 320. We especially support the increased recognition of the need for greater consideration of not only size but also an entity's nature and circumstances when determining materiality and evaluating misstatements. We believe that the proposed standard could be enhanced in several areas that would strengthen audits in both the public and private sectors. Our specific comments are included in the comment letter of the INTOSAI Working Group on Financial Audit Guidelines dated April 22, 2005. The INTOSAI Working Group comment letter includes several suggested enhancements and, most notably, it includes proposed public sector guidance to include in the proposed standard. We believe that the changes proposed by the INTOSAI Working Group would strengthen audits in both the public and private sectors. A copy of the INTOSAI Working Group comment letter is enclosed.

We thank you for considering our comments on this very important issue. We look forward to working with the IAASB and the U.S. auditing standards setting organizations on future issues of mutual interest to strengthen auditing standards globally, both in the public and private sectors.

Sincerely yours,

A handwritten signature in black ink, appearing to read "D. M. Walker", with a long horizontal line extending to the right.

David M. Walker  
Comptroller General  
of the United States

Enclosure

cc:

Mr. Kjell Larsson  
Auditor General of Sweden and  
Chair of the INTOSAI Financial Audit Working Group

The Honorable William H. Donaldson, Chairman  
U.S. Securities and Exchange Commission

The Honorable William J. McDonough, Chairman  
U.S. Public Company Accounting Oversight Board

Mr. John Fogarty, Chair  
U.S. Auditing Standards Board



**Working Group on  
Financial Audit Guidelines**

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

**Subject: Proposed Revisions to International Standard on Auditing  
No. 320 - Materiality in the Identification and Evaluation of  
Misstatements**

This letter provides the comments of the Working Group on Financial Audit Guidelines of the International Organization of Supreme Audit Institutions (INTOSAI) on the proposed revisions to International Standard on Auditing (ISA) No. 320 - *Materiality in the Identification and Evaluation of Misstatements*, issued December 2004. The Working group on Financial Audit Guidelines comprise of experts from the Supreme Audit Institutions of Canada, Cameroon, Namibia, Norway, United States, United Kingdom and Sweden and the comments reflect the opinion of the experts. The Working group also encourages the respective Supreme Audit Institutions to provide comments to proposed International Standards of Auditing.

We commend the International Auditing and Assurance Board (IAASB) for its proposal to enhance the current standard by adding: (1) a heightened emphasis on considering the relevant nature and circumstances in addition to size when determining materiality and evaluating misstatements, (2) the increased emphasis on considering potential management bias, and (3) the emphasis on qualitative issues that may cause the auditor to evaluate some identified misstatements as material even if they are below the materiality level. We also support the analytical framework provided to the auditor in the section on determining materiality when planning the audit and the section on evaluating uncorrected misstatements.

Overall, we support the proposed standard. The enclosure to this letter contains the INTOSAI Working Group's suggestions for adding clarity and rigor to the provisions of the proposed standard listed below. While we are offering comments specifically geared towards public sector audits, we are also offering suggested

changes to the proposed standard that would strengthen audits in both the private and public sectors.<sup>1</sup>

- Format for Public Sector Perspectives
- Add Public Sector Perspective to Introduction (in or after paragraph 3)
- Nature and Causes of Misstatements (paragraph 4)
- Materiality in the Context of an Audit (paragraph 6)
- Clarify Characteristics of Users (paragraphs 8 – 9)
- Use of Percentages of Benchmarks (paragraphs 13 – 14)
- Tolerable Error (paragraph 20)
- Considerations as the Audit Progresses (paragraph 26)
- Evaluating the Effect of Uncorrected Misstatements (paragraph 35)
- Evaluating Whether the Financial Statements as a Whole are Free of Material Misstatement (after paragraph 40)
- Documentation ( paragraphs 45 and 46)

Please note that throughout this document, our suggested additions are indicated with underlined text.

We thank you for considering our comments on this important standard, and we welcome the opportunity to work with the IAASB to develop globally accepted auditing standards for use in both the public and private sectors.

Sincerely yours,



Kjell Larsson  
Auditor General

The Working Group on Financial Audit Guidelines

Enclosure

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<sup>1</sup>In the future, INTOSAI Working Group may supplement this ISA with a practice note to provide supplemental guidance on implementing this standard in the public sector.

**INTOSAI Working Group on Financial Audit Guidelines---Comments on the Proposed Revisions to International Standard on Auditing No. 320**

**Comment 1: Format for Public Sector Perspectives**

The explanatory Memorandum, page 5, asks for comment on whether special considerations for auditors of public sector entities have been dealt with appropriately in the Public Sector Perspective at the end of the proposed ISA. The first preference of the Working Group on Financial Audit Guidelines of the INTOSAI is to have the public sector considerations woven into the fabric of the proposed ISA whenever possible so that the public sector guidance is presented in the relevant context and requirements of the ISA. We are suggesting the addition of specific public sector considerations after paragraphs 3, 6, 9, and 13. (See comments 2, 4, 5, and 6)

However, if adding these public sector considerations to the body of the ISA is not feasible at this time, the INTOSAI Working Group believes that the Public Sector Perspective, as currently presented, needs significant additions to address the issues related to auditing public sector entities. We suggest replacing the current Public Sector Perspective with the following:<sup>3</sup>

1. For governmental entities, auditors may need to set materiality levels based on various legal and regulatory requirements or on the visibility and sensitivity of government programs. Government auditors also may have additional responsibilities for detecting fraud, waste, or abuse that might require different materiality thresholds.

2. As for most entities, the auditor's judgment as to matters that are material to the users of public sector financial statements is based on consideration of the needs of users as a group; the auditor does not consider the possible effect of misstatements on specific individual users, whose needs may vary widely. For public sector entities, legislators are the providers of funding for various government programs, activities, and functions and regulators frequently evaluate or make decisions about an entity's activities. The provision of financial statements that meet the needs of legislators and regulators will also meet most of the needs of other users. These other users may include bondholders, the media, or citizens. In situations where public funds are used, the financial statements may also represent a key element of a government entity's accountability to the public. However the auditor's target user group is generally the group of legislators and regulators who are in the position of providing funding for and making decisions about the government entity under audit.

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<sup>3</sup> INTOSAI's Working Group may also choose to supplement this Public Sector Perspective with a practice note in the future that provides supplemental guidance in implementing this ISA even if this language is adopted.

**INTOSAI Working Group on Financial Audit Guidelines---Comments on the Proposed Revisions to International Standard on Auditing No. 320**

3. Materiality has both quantitative and qualitative aspects. Qualitative aspects could include: 1) account balances or transactions that are considered sensitive to users of the financial statements; 2) misstatements that have a significant effect on the entity's annual report, including the entity's performance indicators; and 3) misstatements that offset one another in the aggregate but are individually significant. In the public sector, qualitative issues such as public interest and ensuring effective legislative oversight and regulation should be considered when assessing whether an item is material by virtue of its nature. This is particularly so for items that relate to compliance with regulation, legislation, or other authority.

4. The auditor often will apply a percentage to a chosen benchmark as a step in determining materiality for the financial statement as a whole. When identifying an appropriate benchmark for government entities, an appropriate benchmark may be total cost or net cost (expenses less revenues or expenditures less receipts) for program activities. In situations where a governmental entity has custody of public assets, then assets may be an appropriate benchmark.

*Note: The comments that follow include the paragraphs from the Public Sector Perspectives presented in Comment 1 above. Comments 2, 4, 5, and 6 propose including these paragraphs in the body of the ISA within the relevant context and requirements of the ISA.*

**Comment 2: Add Public Sector Perspective to Introduction (in or after Paragraph 3)**

We recommend adding the following public sector perspective to the Introduction section of the proposed changes:

For governmental entities, auditors may need to set materiality levels based on various legal and regulatory requirements or on the visibility and sensitivity of government programs. Government auditors also may have additional responsibilities for detecting fraud, waste, or abuse that might require different materiality thresholds. [Also discussed in comment 1, suggested public sector perspective, paragraph 1]

**INTOSAI Working Group on Financial Audit Guidelines---Comments on the Proposed Revisions to International Standard on Auditing No. 320**

**Comment 3: Nature and Causes of Misstatements (Paragraph 4)**

We recommend adding management bias to the causes of potential misstatements, as follows, in order to link the discussion of causes of potential misstatements to the discussion about management bias presented in paragraph 40 of the proposed ISA.

Proposed changes:

**Nature and Causes of Misstatements**

4. Misstatements can arise from error or fraud and may consist of:

- (a) An inaccuracy in gathering or processing data from which financial statements are prepared;
- (b) A difference between the amount, classification, or presentation of a reported financial statement item and the amount, classification, or presentation that is required for the item to be in accordance with the applicable financial reporting framework;
- (c) An omission of an amount or disclosure that is required by the applicable financial reporting framework, or is otherwise needed for the fair presentation of the financial statements;
- (d) An incorrect accounting estimate arising, for example, from an oversight or misinterpretation of facts; and
- (e) Differences between management's and the auditor's judgments concerning accounting estimates, the selection and application of accounting policies that the auditor considers inappropriate, or possible management bias.

**INTOSAI Working Group on Financial Audit Guidelines---Comments on the Proposed Revisions to International Standard on Auditing No. 320**

**Comment 4: Materiality in the Context of an Audit (Paragraph 6)**

We recommend adding context after the definition of materiality to more clearly explain the qualitative and quantitative aspects of materiality as well as the use of the concept of materiality throughout the audit. We also suggest adding a paragraph that includes public sector considerations.

Proposed changes:

6. Materiality in this context can be defined in the following terms:

“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.”

Materiality has both quantitative and qualitative aspects. Even though quantitatively immaterial, certain types of misstatements could have a material impact on or warrant disclosure in the financial statements for qualitative reasons.

Qualitative aspects could include: 1) account balances or transactions that are considered sensitive to users of the financial statements; 2) misstatements that have a significant effect on the entity's annual report, including the entity's performance indicators; and 3) misstatements that offset one another in the aggregate but are individually significant.

The auditor should apply the concept of materiality throughout the overall audit, planning, sample selection, and risk assessment in such a manner that overall audit risk is reduced to an acceptable level.

In the public sector, issues such as public interest and ensuring effective legislative oversight should be considered when assessing whether an item is material by virtue of its nature. This is particularly so for items that relate to compliance with regulation, legislation, or other authority. [Also discussed in comment 1, suggested public sector perspective, paragraph 3]



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**Comment 5: Clarify Characteristics of Users (Paragraphs 8 – 9)**

The following changes are intended to clarify the discussion on users of financial statements. We suggest revising Paragraph 8(b) to provide linkage between materiality and overall audit risk as well as deleting the discussion of the cost and timing of the audit. In addition, we suggest that paragraph 8(a) be revised to indicate that users are assumed to have a reasonable knowledge of the entity's industry and that paragraph 8(d) be revised to indicate that normally the financial statements are not the sole source of information available to users. Our proposed changes to this section also include a public sector comment after paragraph 9 to provide guidance on the characteristics of users of financial statements for public sector entities.

Proposed changes:

8. The evaluation of whether a misstatement could influence economic decisions of users, and so be material, involves consideration of the characteristics of those users. Users are assumed to:

- (a) Have a reasonable knowledge of business and economic activities, accounting, and the entity's industry, and a willingness to study the information in the financial statements with reasonable diligence;
- (b) Understand that financial statements are prepared and audited to levels of materiality and that there is a relationship between the level of materiality used and overall audit risk, and the extent of testing;

**Deleted:** the cost and timing of the audit;

(c) Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and

(d) Make reasonable economic decisions on the basis of the information in the financial statements and from other relevant sources.

The determination of materiality, therefore, takes into account how users with such characteristics could reasonably be expected to be influenced in making economic decisions.

9. In an audit of general purpose financial statements, the auditor's judgment as to matters that are material to users of financial statements is based on consideration of the needs of users as a group; the auditor does not consider the possible effect of misstatements on specific individual users, whose needs may vary widely. The International Accounting Standards Board's "Framework for the Preparation and Presentation of Financial Statements" (the IASB's Framework) indicates that, for a profit oriented entity, as investors are providers of risk capital to the enterprise, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy. In the audit of such

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entities, therefore, the collective needs of investors as a group is an appropriate frame of reference when determining materiality.

As indicated in paragraph 9, for a profit oriented entity, as investors are providers of risk capital to the enterprise, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy. For public sector entities, legislators are the providers of funding for various government programs, activities, and functions and regulators frequently evaluate or make decisions about an entity's activities. The provision of financial statements that meet the needs of legislators and regulators will also meet most of the needs of other users. These other users may include bondholders, the media, or citizens. In situations where public funds are used, the financial statements may also represent a key element of a government entity's accountability to the public. However the auditor's target user group is generally the group of legislators and regulators who are in the position of providing funding for and making decisions about the government entity under audit. [Also discussed in comment 1, suggested public sector perspective, paragraph 2]

**Comment 6: Use of Percentages of Benchmarks (Paragraphs 13 – 14)**

We are concerned that the illustrative examples of percentages applied to benchmarks increase the likelihood that these percentages will become the default percentages used by auditors. For this reason, we believe that paragraph 14, which includes specific percentages, should be removed from the proposed ISA and instead that the standard should discuss only appropriate potential benchmarks, as presented in paragraph 13. If the IAASB elects to retain paragraph 14, we disagree with the illustrative percentages used as they do not consider other, potentially significant balances that may need to be considered in relation to the illustrative benchmarks before the auditor selects a specific percentage. In addition, auditors may have good reasons for selecting percentages that differ from those shown in paragraph 14, but could have their judgment questioned simply because it is different from the percentages shown in paragraph 14. If IAASB elects to use illustrative percentages in the ISA, we suggest a re-evaluation of the illustrative percentages or use of ranges of percentages that the auditor may consider. Alternatively, specific percentages or a range of percentages may be more appropriately presented in an appendix or other guidance materials. Our proposed changes to these paragraphs also include a public sector comment appearing after paragraph 13.

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Proposed changes:

**Use of Percentages of Benchmarks**

13. The determination of what is material to the users is a matter of professional judgment. The auditor often applies a percentage to a chosen benchmark as a step in determining materiality for the financial statements as a whole. When identifying an appropriate benchmark, the auditor has regard to factors such as:

- The elements of the financial statements (e.g., assets, liabilities, equity, income and expenses) and the financial statement measures defined in the applicable financial reporting framework (e.g., financial position, financial performance and cash flows), or other specific requirements of that framework;
- Whether there are financial statement items on which, for the particular entity, users' attention are likely to be focused (e.g., for the purpose of evaluating financial performance);
- The nature of the entity and the industry in which it operates; and
- The size of the entity, nature of its ownership and the way it is financed.

**Deleted:** tends

Examples of benchmarks that might be appropriate, depending on the nature and circumstances of the entity, include total revenues, gross profit and other categories of reported income, such as profit before tax from continuing operations. Profit before tax from continuing operations may be a suitable benchmark for profit oriented entities but may not be an appropriate benchmark for the determination of materiality when, for example, the entity's earnings are volatile, when the entity is a not-for-profit entity or when it is an owner managed business where the owner takes much of the pre-tax income out of the business in the form of remuneration. For asset based entities (e.g., an investment fund) an appropriate benchmark might be net assets.

For government entities, an appropriate benchmark may be total cost or net cost (expenses less revenues or expenditures less receipts) for program activities. In situations where a governmental entity has custody of public assets, then assets may be an appropriate benchmark. [As discussed in comment 1, suggested public sector perspective, paragraph 4]

**Deleted:** 14. Illustrative examples of percentages applied to benchmarks that might be considered include the following:¶  
• For a profit oriented entity, five a percent of profit before tax from continuing operations, or one half of one percent of total revenues.¶  
• For a not-for-profit entity, one half of one percent of total expenses or total revenues.

**Deleted:** • For an entity in the mutual fund industry, one half of one percent of net asset value.

**Deleted:** The auditor may consider higher or lower percentages than those illustrated above to be¶ appropriate.¶

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**Comment 7: Tolerable Error (Paragraph 20)**

We suggest that Paragraph 20 of the ISA be revised to include footnote 3 in the text of paragraph 20 since the definition of tolerable error is critical to the auditor's consideration of materiality.

Proposed changes:

**Tolerable Error**

Deleted: '

**20. The auditor should determine one or more levels of tolerable error for classes of transactions, account balances and disclosures. Tolerable error is the maximum error in a population (e.g., the class of transactions or account balance) that the auditor is willing to accept.**

**Comment 8: Considerations as the Audit Progresses (Paragraph 26)**

We agree that the auditor cannot assume that a misstatement is an isolated occurrence. However, paragraph 26 does not clearly state what the auditor should do in this situation. Therefore we suggest adding a sentence to clearly state that the auditor should consider the possibility of further errors.

Proposed changes:

**26. The auditor cannot assume that a misstatement is an isolated occurrence. For identified misstatements, the auditor should consider the possibility of further errors. Evidence that other misstatements may exist include, for example, where the auditor identifies that a misstatement arose from a breakdown in internal control or from inappropriate assumptions or valuation methods that have been widely applied by the entity. In such circumstances the auditor evaluates whether the overall audit strategy and audit plan, and consequently the nature, timing and extent of further audit procedures need to be reconsidered to reduce audit risk to an acceptably low level.**

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**Comment 9: Evaluating the Effect of Uncorrected Misstatements (Paragraph 35)**

We recommend adding the words “known and likely” before “misstatements” in paragraph 35 to add further clarity to the standard and to help ensure that auditors consider both known and likely misstatements when evaluating the effect of uncorrected misstatements.

Proposed changes:

**35. The auditor should evaluate whether uncorrected misstatements that have been identified during the audit are material, individually or in aggregate. In making this evaluation, the auditor should consider the size and nature of the known and likely 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.**

**Comment 10: Evaluating Whether the Financial Statements as a Whole are Free of Material Misstatement (after Paragraph 40)**

We suggest adding a paragraph after paragraph 40 to specify that the auditor should consider the uncorrected known and likely misstatements and the risk of further misstatements along with overall audit risk when evaluating whether the financial statements as a whole are free of material misstatements.

Proposed changes:

After paragraph 40:

**XX. The auditor should consider known and likely uncorrected misstatements combined with the risk of further misstatements in relation to materiality when evaluating whether the financial statements as a whole are free of material misstatement. Based on the results of this evaluation, the auditor should determine whether sufficient audit work was completed to reduce audit risk to an acceptable level.**

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**Comment 11: Documentation (Paragraphs 45 and 46)**

We recommend adding the words “known and likely” before “misstatements” in paragraphs 45(b), 46 (b), and 46 (c) to clarify the documentation requirements to help ensure that auditors consider both known and likely misstatements when evaluating the effect of uncorrected misstatements. In addition, we suggest adding clarity and rigor to the standard by inserting (d) and (e) to the requirements of items that need to be documented as follows:

Proposed changes:

**Documentation**

**45. The auditor should document:**

- a. **The levels of materiality and tolerable error, including any changes thereto, used in the audit and the basis on which those levels were determined;**
- b. **A summary of uncorrected known and likely misstatements, other than those that are clearly trivial, related to known and likely misstatements;**
- c. **The auditor’s conclusion as to whether uncorrected known and likely misstatements individually or in aggregate, do or do not cause the financial statements to be materially misstated, and the basis for that conclusion;**
- d. **The auditor’s evaluation of materiality in relation to known and likely uncorrected misstatements combined with the risk of further misstatements and uncertainties from untested areas; and**
- e. **The auditor’s determination whether sufficient audit work was completed to reduce audit risk to an acceptable level.**

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

(a) Separately consider the effects of:

- (i) Known misstatements, distinguishing between misstatements of fact and misstatements involving subjective decisions; and
- (ii) Likely misstatements;

(b) Consider the aggregate effect of known and likely misstatements, combined with the risk of further misstatements, on the financial statements; and

(c) Assess the effect of known and likely misstatements on particular groups of accounts, segment information, ratios, trends and compliance with legal, regulatory and contractual requirements (e.g., debt covenants).