Hong Kong Institute of
Certified Public Accountants
香港會計師公會

26 May 2005

By e-mail < Edcomments@ifac.org > and by fax (0062 1 212 286 9570)

Our Ref.: C/AASC

Technical Director,
International Auditing and Assurance Standards Board,
International Federation of Accountants,
545 Fifth Avenue, 14th Floor,
New York,
New York 10017,
USA.

Dear Sir,

IAASB Exposure Draft on ISA 320 (Revised)
"Materiality in the Identification and Evaluation of Misstatements"

The Hong Kong Institute of Certified Public Accountants welcomes the opportunity to provide you with our comments on the captioned IAASB Exposure Draft.

--- We set out in the attachment our comments on the proposed revised ISA 320 for your consideration.

We trust that our comments are of assistance to you. If you require any clarifications on our comments, please contact the undersigned at schan@hkicpa.org.hk.

Yours faithfully,

Stephen Chan

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ATTACHMENT

HONG KONG INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
COMMENTS ON THE IAASB EXPOSURE DRAFT ON ISA 320 (REVISED)
"MATERIALITY IN THE IDENTIFICATION AND EVALAUTION OF MISSTATEMENTS"

We are supportive of the proposed revision to ISA 320 and believe it is both important and helpful to practitioners. However, we have the following general and specific comments which we request that they be considered carefully by the IAASB before finalizing the revised ISA.

GENERAL COMMENTS

We would like to take this opportunity to mention that we are in agreement with the IAASB's approach in setting Auditing Standards in recent years that sought to increase the use of professional judgement and the need for professional skepticism to be exercised, whilst at the same time providing additional guidance to auditors as to how judgement and skepticism can be applied. However, we do appreciate and recognize that it has not always been an easy task as the use of professional judgement could be affected by a detailed level of prescriptive guidance. Furthermore, if detailed guidance is placed in the body of the Auditing Standards, this could increase the tendency for auditors, regulators and others to interpret the detailed guidance in a legalistic manner and therefore would be counterproductive. Accordingly, we request that the IAASB bears this in mind when formulating new Auditing Standards that aims to improve audit quality and consider whether detailed guidance could be appropriately placed in an appendix to the Auditing Standard. This would hopefully also remove the notion that new Auditing Standards are lengthy and complex.

SPECIFIC COMMENTS

1. Nature and Causes of Misstatements – Paragraph 4

Paragraph 4 (non bold) states that 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, or the selection and application of accounting policies that the auditor considers inappropriate.

In this regard, we are broadly in agreement on the nature and causes but is of the view that the guidance would benefit from an overarching principle or definition of a misstatement. We would recommend that the IAASB reconsider the structure of paragraph 4 by introducing paragraph 4(b) as an overriding principle as follows:

A misstatement is a difference between an 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. A misstatement can arise from error or fraud. Examples of misstatements include:

(a) An inaccuracy in gathering or processing data from which financial statements are prepared;

(b) 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;

(c) An incorrect accounting estimate arising, for example, from an oversight or misinterpretation of facts; and

(d) 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 believe that the proposed overarching principle would link appropriately with the principle or definition to the objective of the audit which is "to enable the auditor to express an opinion whether the financial statements are prepared in all material respects, in accordance with an applicable financial reporting framework"(ISA 200 (revised) paragraph 2 refers).

2. Assumptions about Users of Financial Statements – Paragraph 8

Paragraph 8 (non bold) states that the evaluation of whether a misstatement could influence economic decisions of users, and so be material, involves consideration of the characteristics of those users and users are assumed to:

(a) Have a reasonable knowledge of business and economic activities and accounting 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 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.

We are of the opinion that the second sentence in paragraph 8(b) highlighted in bold above should be deleted as it is confusing. It could be interpreted to mean that setting a higher materiality level will result in a more cost effective audit.

3. <u>Use of Percentages as Benchmarks – Paragraphs 13 and 14</u>

Paragraph 14 (non bold) states that illustrative examples of percentages applied to benchmarks that might be considered include the following:

- For a profit oriented entity, five 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.
- For an entity in the mutual fund industry, one half of one percent of net asset value.

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

In this regard, we are of the view that the inclusion of percentages in the body of the standard is likely to result in the interpretation of those percentages by auditors and regulators as rules, regardless of intentions. Accordingly, it might encourage those responsible for inspecting or monitoring an audit engagement to focus on why the practitioner had not applied the illustrative examples in paragraph 14, rather than consider how the practitioner determined a particular percentage. Furthermore, practitioners may adopt the illustrative examples without applying the proper thought process and giving proper regard to the factors identified in paragraph 13. The indiscriminate application of percentages as rules will lead to a deterioration in the quality of audits.

We recommend that the illustrative examples of percentages be placed in an appendix to the proposed revised ISA 320 instead of the body of the Standard.

4. <u>Materiality is determined without regard to the degree of inherent uncertainty associated with the measurement of particular items - Paragraph 16</u>

Paragraph 16 (non bold) states that materiality is determined without regard to the degree of inherent uncertainty associated with the measurement of particular items. 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 higher than for financial statements that do not include such inherent estimation uncertainties.

Whilst this paragraph may be correct, we consider that it is not particularly helpful to the practitioner and is counter-intuitive. We would suggest that further explanation be provided in the context of the audit risk model or that the paragraph be deleted.

5. **<u>Materiality for particular items of lesser amounts than the materiality level determined for the financial statements as a whole – Paragraphs 17 to 19</u>**

Paragraph 17 (bold) states when establishing the overall strategy for the audit, the auditor should consider whether, in the specific circumstances of the entity, misstatements of particular items of lesser amounts than the materiality level determined for the financial statements as a whole, if any, could, in the auditor's judgment, reasonable be expected to influence economic decisions of users taken on the basis of the financial statements. Paragraph 18 (non bold) provides examples of certain factors the auditor could consider.

In this regard, we consider that additional guidance and clarification are required as it could be interpreted that there is a requirement for two different levels of materiality, which we believe are not the intention of these paragraphs.

6. **<u>Tolerable Error – Paragraph 20</u>**

Paragraph 20 (bold) states that the auditor should determine one or more levels of tolerable error for classes of transactions, account balances and disclosures.

In this regard, we consider that the term "tolerable error" (in order not to confuse with the same term used in ISA 530 "Audit Sampling and Other Selective Testing Procedures") be replaced by using another term "Planning Materiality". We believe the proposed term "Planning Materiality" is appropriate because it is being used in the context of trying to describe how the concept of materiality is used by the auditor to plan which account balances, classes of transactions and disclosures to select for examination and as an input to the selection of audit procedures that are appropriate in the circumstances in order to obtain sufficient, appropriate audit evidence. Furthermore, we recommend that further guidance on "Planning materiality" be provided to include examples of factors that might influence an auditor's decision when determining levels of planning materiality like, the nature and extent of audit adjustments found in previous audits on recurring audits, the design of relevant controls and whether or not testing of them in previous audits has historically shown them to be operating effectively and the degree of inherent uncertainty associated with the measurement of particular items.

7. **<u>Known misstatements – Paragraph 31</u>**

Paragraph 31 (non bold) states that when communicating details of misstatements the auditor distinguishes between "Known misstatements" and "Likely misstatements", separately identifying "Known misstatements" as misstatements of fact or misstatements involving subjective decisions. Misstatements involving subjective decisions are described as those arising from differences between management's and the auditor's judgments concerning accounting estimates or the selection and application of accounting policies that the auditor considers to give rise to misstatements.

In this regard, we do not agree that a "misstatement involving subjective decisions" can be a "known misstatement" before there has been discussion with management. This is because it is not known, for a fact, which of the two estimates is the correct amount and hence what the misstatement is. Furthermore, both management and auditor's estimates could be equally incorrect. Accordingly, we would suggest that the term "Known misstatements" and "Likely misstatements" be replaced by the following three categories to avoid confusion:

- **Misstatement of fact**
- **Misstatement involving subjective decision**
- **Projected misstatements**

8. <u>Correction of all misstatements – Paragraph 32</u>

Paragraph 32 (bold) states that the auditor should request management to correct all known misstatements, other than those that the auditor believes are clearly trivial. Where the auditor evaluates the amount of likely misstatement in a class of transactions, account balance or disclosure as material, either individually or in aggregate with other misstatements, the auditor should request management to examine the class of transactions, account balance or disclosure in order to identify and correct misstatements therein.

In this regard, we agree with the first sentence of the paragraph and believe that the auditor should ask management to correct all errors but do not agree that the auditor should request management to examine the class of transactions, account balance or disclosure in order to identify and correct the misstatements therein. We consider that it is up to management to do more work as a result of the auditor's request to correct the misstatements, and that is management's choice.

9. <u>Evaluating the effect of uncorrected misstatements – Paragraph 36(b)</u>

Paragraph 36(b) (non bold) states that to evaluate whether, in considering the effect of the individual misstatement on the financial statements as a whole, it is appropriate to offset misstatements. For example, it may be inappropriate to offset misstatements of items that are disclosed separately in the financial statements.

In this regard, we consider that the guidance should be strengthened. The wording as it stands implies that the offset of misstatements is the norm, where in fact the reverse is true. Furthermore, if a misstatement is judged to be material then it is unlikely that it can be eliminated, or offset, by other misstatements, unless they happen to affect exactly the same line items and segments (and only then if the offsetting items are not individually material).

10. Management bias – Paragraph 40

Paragraph 40 (non bold) mentions that during the audit, the auditor is alert for possible bias in management's judgements.

In this regard, we are of the view that management bias is an important aspect of materiality and is worthy of mention in the introductory paragraphs of the Standard rather than fairly late in the proposed Standard.

26 May 2005