

**Copy of letter sent by the Task Force to the Chairman of IAASB**

24 June 2003

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IAASB Chairman  
International Federation of Accountants  
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**Recommendations of the Materiality Task Force**

I am writing in my capacity as the Chairman of the joint Materiality Task Force of the IAASB and the Auditing Practices Board of the United Kingdom and Ireland (the Task Force).

**“Tolerable error” and materiality of “other information”**

The Task Force has considered whether the proposed exposure draft of the revised ISA 320 “Audit Materiality” should address the topics of “tolerable error” and materiality of “other information” included in documents containing audited financial statements. The Task Force has concluded that it should not, but recommends that the following ISAs should be revised in due course to provide further guidance on these matters:

- 530 “Audit Sampling and Other Selective Testing Procedures”
- 720 “Other Information in Documents Containing Audited Financial Statements”

As you know, a project to revise ISA 530 is under consideration by IAASB but there is no project under consideration currently to revise ISA 720.

**TOLERABLE ERROR**

Tolerable error is defined in IAASB’s Glossary of Terms and in ISA 530 as “the maximum error in a population that the auditor is willing to accept.” ISA 530 also states (in paragraph 51) that “For substantive procedures, tolerable error is the tolerable misstatement, and will be an amount less than or equal to the auditor’s preliminary estimate of materiality used for the individual account balances being audited.”

Different auditors have different methods for calculating “tolerable error”. For example, some determine a single amount for use in testing all account balances, others determine separate amounts that may be in proportion to the size of the account balances. The determination is often based on a percentage of materiality, with percentage used related to an estimate of the risk of error (lower percentages are used where the risk of expected misstatement is considered to be higher). The exercise of judgment in setting tolerable error is important.

The Task Force believes that a revised ISA 530 could better explain the relationship between tolerable error and materiality and also provide more guidance on how tolerable error may be determined. The Task Force does not believe that these matters should be addressed in ISA 320 since they are directly related to audit sampling and do not affect the determination of materiality.

## OTHER INFORMATION

ISA 320 does not specifically address materiality in the context of the auditor's consideration of other information, on which the auditor has no obligation to report, in documents containing audited financial statements. The matter is addressed in ISA 720.

Relevant extracts from ISA 720 are:

- “2. **The auditor should read the other information to identify material inconsistencies with the audited financial statements.**
3. A “material inconsistency” exists when other information contradicts information contained in the audited financial statements. A material inconsistency may raise doubt about the audit conclusions drawn from audit evidence previously obtained and, possibly, about the basis for the auditor's opinion on the financial statements.”
- “14. While reading the other information for the purpose of identifying material inconsistencies, the auditor may become aware of an apparent material misstatement of fact.
15. For the purpose of this ISA, a “material misstatement of fact” in other information exists when such information, not related to matters appearing in the audited financial statements, is incorrectly stated or presented.”

Taken literally, the wording of the definitions in paragraphs 3 and 15 of ISA 720 means that any contradictory information identified constitutes a material inconsistency, and any incorrectly stated or presented information identified constitutes a material misstatement of fact (i.e. the materiality level is zero). ISA 720 would be improved by incorporating a definition of materiality based on that given in ISA 320.

Other guidance that the Task Force is developing, for example with respect to the factors that are considered when determining whether an item is material, may also be helpful to consideration of “other information”.

The Task Force suggests that IAASB should add ISA 720 to the revisions agenda. In summary, matters that might be addressed are:

- A proper definition of materiality, consistent with that provided in ISA 320;
- Guidance on the factors to be considered when determining whether an inconsistency or misstatement in “other information” is material;
- Guidance on matters that may be considered particular issues in respect of the materiality of “other information”, for example:
  - non financial information;
  - areas where factual information is not easily distinguishable from judgement;
  - directors' judgments which the auditor cannot ‘second guess’;
  - forward looking information.

**The Terms “Management” and “Those Charged with Governance”**

The IAASB's Glossary of Terms defines these as follows:

*Management* - Management comprises officers and others who also perform senior managerial functions. Management includes directors and the audit committee only in those instances when they perform such functions.

*Governance* - The term “governance” describes the role of persons entrusted with the supervision, control and direction of an entity. Those charged with governance ordinarily are accountable for ensuring that the entity achieves its objectives, financial reporting, and reporting to interested parties. Those charged with governance include management only when it performs such functions.

The term “those charged with governance” is a relatively new addition to the Glossary and to ISAs. The split of responsibilities between management and those charged with governance is not always clear and is exacerbated by structures of governance varying from country to country and within different types of entity (e.g. in smaller entities, management and those charged with governance are often the same individuals). This is recognised in ISA 260, “Communications of Audit Matters to Those Charged With Governance” which includes several paragraphs of guidance in relation to determining those persons who are charged with governance. The guidance in ISA 260 is not, however, included in the Glossary or in other ISAs which are now incorporating the term.

A particular issue that the Task Force has encountered is how to refer to those individuals in an entity who are responsible for approving and issuing the financial statements. This has led to the rather unsatisfactory inclusion in its draft exposure draft of the term “those who are responsible for approving and issuing the financial statements.”

Given the increasing importance that is likely to attach to the distinction between the responsibilities of management and those charged with governance, the Task Force believes that IAASB needs to clarify the definitions.

If you wish to discuss any of the comments set out in this letter, please would you let me know. My telephone number is 44 (20) 7804 3101.

Graham Ward

Chairman, Materiality Task Force

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