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October 31, 2007

Mr. Jim Sylph
Executive Director, Professional Standards
International Federation of Accountants
545 Fifth Avenue, 14th Floor
New York, NY 10017

Dear Mr. Sylph:

We appreciate this opportunity to comment on proposed International Standard on Auditing (ISA) 530, *Audit Sampling* (the "proposed standard") as developed by the International Auditing and Assurance Standards Board (IAASB). We are supportive of the development of this guidance and believe that the overall redrafting of the proposed standard was completed in accordance with the clarity conventions and criteria adopted by IAASB.

We recognize that the IAASB has requested comments only on changes resulting from applying the clarity drafting conventions. However, in addition to our comments on the clarity redrafting of the proposed standard, we have included two non-clarity comments because we believe that they relate to current practice problems and that their significance warrants the IAASB's consideration at this time.

As you will read in our "Overall Comments" below, we are concerned that the continued exclusion of anomalous misstatements when projecting misstatements in audit samples to the population, as well as the application of the protocol described for evaluating sample results, will often lead auditors to draw inappropriate conclusions. We believe the auditor should project all misstatements or deviations in a sample, or alternatively, determine whether the sample is so unrepresentative that an extension of the original sample or selection of a separate sample is appropriate. We strongly urge the IAASB to take this opportunity to revise its standards in these areas to promote better auditing now rather than perpetuate bad practice.

Within our recommendations for editorial changes, additions are noted in "bold underline" and deletions in "double strike-through."

RESPONSES TO QUESTIONS IN THE EXPLANATORY MEMORANDUM

1. *Are the objectives to be achieved by the auditor, stated in the proposed redrafted ISA, appropriate?*

Yes, we believe that the objectives are appropriate.

2. *Have the criteria identified by the IAASB for determining whether a requirement should be specified been applied appropriately and consistently, such that the resulting requirements promote consistency in performance and the use of professional judgment by auditors?*

Yes, we believe that the criteria identified by the IAASB for determining whether a requirement should be specified have been applied appropriately and consistently.

OVERALL COMMENTS

Anomalies - paragraphs 5(m), 13, A16, A18 and A19

Paragraph 5(m) of the proposed standard defines an anomaly as "A misstatement or deviation that is demonstrably *not representative* of misstatements or deviations in a population." Paragraph 13 states that, "In the extremely rare circumstances when the auditor considers a misstatement or deviation discovered in a sample to be an anomaly the auditor shall obtain a high degree of certainty that such misstatement or deviation is *not representative* of the population." [Emphasis added.] Finally, paragraph A18 states that, "When a misstatement has been established as an anomaly, it may be excluded when projecting misstatements in samples to the population."

We believe that the proposed standard confuses and misapplies the concept of "representative." The purpose of a representative sample is to identify items in a population that are representative of the total population. "Representative" in this context does not mean that the ***nature*** of selected misstatements should be representative of the nature of misstatements in the population as implied by paragraph 5(m). All it means is that the ***incidence*** of misstatement in the sample should approximate the incidence of misstatement in the population. If the sample is selected in a representative manner, this ought to be the outcome, subject, of course, to sampling risk. Indeed, this is the point of representative sampling: the ability to examine 100 items out of 10,000 and draw some (probabilistic) conclusion about the unexamined 9,900. The fact that some misstatements can be traced to provably unique causes is irrelevant when it comes to whether or not to count them as misstatements for the purpose of projection. It is hard to imagine circumstances under which the auditor may justifiably assume that the unexamined part of the population does not contain its own different (possibly anomalous) misstatements. While this comment is written in the context of misstatements, it also applies to deviations.

The proposed standard's suggestion that auditors will encounter anomalies only "in extremely rare circumstances" provides no comfort. Armed with an authoritative definition of anomaly, the auditor will look at each specific misstatement to determine whether it is anomalous or not, and will be ISA-compliant in not projecting it if it is. In some populations anomalies may indeed be extremely rare; in others there may be many of them. Which it is, is a matter of specific facts and circumstances.

Our comment is not meant to suggest that appropriately selected samples are always representative. They are not; which is what sampling risk implies. In those rare circumstances when the auditor believes that a sample is so unrepresentative that its projection would result in an incorrect conclusion, the appropriate response is to redo or expand the sample, or to audit the remaining population in some other way.

When the auditor investigates the nature and cause of a misstatement, it is important to know whether the misstatement is an anomaly or indicative of a wider problem. However, the proposed standard more or less already says that in Paragraph A15 without requiring the concept of an anomaly.

We strongly believe that the proposed exclusion of anomalies when projecting misstatements in samples to the population is untenable and will perpetuate bad practice in sample evaluation. We recommend that the IAASB delete paragraph 5(m) and make the other changes necessary to eliminate the concept of anomalous misstatements and deviations from the proposed standard within paragraphs 13, A16, A18 and A19.

Sample Evaluation - paragraphs A19 and A20

Currently, paragraph A19 discusses evaluating sample results in general, whether the audit sample is statistical or non-statistical. Paragraph A20 gives the auditor the option of using estimated maximum misstatement when the audit sample is statistical. We are concerned that the evaluation protocol described in paragraph A19 will often lead auditors to believe that they have reduced audit risk to an acceptably low level when in fact they have not. This concern is further discussed and illustrated in the Appendix to this letter.

We believe that the evaluation of comparable statistical and non-statistical representative samples ought to yield roughly comparable results. The factors that are considered in both cases should be the same conceptually even though in the non-statistical case they may not be as readily or as accurately quantified nor the evaluation performed with the same degree of mathematical rigor. Specifically, the concepts of projected misstatement and estimated maximum misstatement, while more easily described and calculated for statistical sampling, apply equally to non-statistical sampling.

We believe that, in the absence of formal theoretical bases for evaluating and interpreting non-statistical samples, a pragmatic surrogate approach is often to treat such samples as if they were statistical and to compute the statistics anyway. Such statistics, while beyond the reach of formal theory, are not necessarily useless or invalid in a broader sense.

Indeed, projected misstatement, which the proposed standard requires to be calculated for all audit samples, is just such a statistic when the basis is not a statistical sample. Everyday experience is that most of the estimates and projections that people make have no formal statistical basis; but they make them anyway and no-one thinks twice about it. The evaluation of non-statistical samples using methods derived from statistical theory can provide credible best-effort, if not perfect, benchmarks to inform the auditor's professional judgment.

We recommend that the IAASB amend or replace paragraph A19 because the evaluation protocol it describes will often lead auditors to believe that they have reduced audit risk to an acceptably low level when they have not. We further recommend that the IAASB amend the proposed standard to extend the concept of estimated maximum misstatement to sample evaluations in general, including the comparison of estimated maximum misstatement with tolerable misstatement for the purpose of determining what conclusion may be drawn from the sample, as described in paragraph A20.

COMMENTS BY PARAGRAPH

- **Paragraph 5(j):**

We believe the word "reasonably" should be inserted before the phrase "possible misstatements" in the definition of "estimated maximum misstatement." This change would make the definition consistent with that in Appendix 5, paragraph 2. It would also clarify what is intended by the "range of possible misstatements" because any amount of misstatement may be possible, though a large amount may be improbable.

- **Paragraph 5(k):**

Similar to the comment on paragraph 5(j), we believe the word "reasonably" should be inserted before the phrase "possible rates of deviation."

- **Paragraph A8 and Appendix 1:**

We suggest "value-weighted" rather than "value weighted."

- **Paragraph A15**

The second sentence of paragraph A15 misuses the term "stratum." Accordingly, we recommend the following revision:

> A15. In analyzing the deviations and misstatements identified, the auditor may observe that many have a common feature, for example, type of transaction, location, product line or period of time. In such circumstances, the auditor may decide to identify all items in the population that possess the common feature, and extend audit procedures ~~in that stratum~~ **to those items**. In addition, such deviations or misstatements may be intentional, and may indicate the possibility of fraud.

- **Paragraph A16**

If paragraph A16 is not deleted in accordance with our previous overall comment on anomalies, we suggest the following editorial revision for ease of reading:

> A16. The smaller the **size of the** sample ~~size~~ in which the misstatement or deviation occurs…

We would be pleased to discuss our letter with you or your staff at your convenience. If you have any questions, please contact Jens Simonsen, Director of Global Audit Services at + 1 212 492 3689 or John Fogarty, Chairman – DTT Assurance Technical Policies and Methodologies Group at + 1 203 761 3227.

Very truly yours,

Appendix – Example of Using "Estimated Maximum Misstatement" to Evaluate Sample Results

By focusing on misstatements and eliminating the mention of anomalies (see comment above), current paragraph A19 can be simplified as follows:

A. When projected misstatement exceeds tolerable misstatement, the sample does not provide an appropriate basis for conclusions about the population that has been tested.

B. If projected misstatement is less than but close to tolerable misstatement, the auditor may consider the persuasiveness of the sample results in the light of other audit procedures, and may consider it appropriate to obtain additional audit evidence. However, projected misstatement is affected by sampling risk. Therefore, when projected misstatement is close to tolerable misstatement, the auditor recognizes the risk that a different sample would result in a different projected misstatement that could exceed tolerable misstatement. Considering the results of other audit procedures helps the auditor to assess this risk, while the risk is reduced if additional audit evidence is obtained.

Paragraph A is clearly true. Paragraph B, on the other hand, does not describe a generally valid protocol for dealing with situations in which projected misstatement is less than tolerable misstatement.

This is best explained by way of an example. We will use an illustration from statistical sampling (Paragraph A19 applies to all forms of audit sampling) where correct methods of evaluation are well established in theory and practice. Assume that the auditor seeks 95% confidence that total misstatement does not exceed tolerable misstatement; that tolerable misstatement is $300, which is 1% of the population; that no reliance is placed on internal controls or other audit procedures; and that a monetary unit sampling (MUS) technique is employed.

Many MUS plans would indicate a sample of 300 items in this case, which, if no misstatements are detected, is sufficient to provide 95% confidence that total misstatement does not exceed $300, the amount of tolerable misstatement. Suppose, however, that one misstatement is detected: a $10 recorded item with an audited value of zero. MUS would indicate a projected misstatement of $100. Because this is not close to tolerable misstatement, paragraph A19 does not apply. Based on the proposed standard, the auditor may therefore believe that there is an appropriate basis for concluding with reasonably high confidence (95% presumably) that total misstatement does not exceed $300. But in reality there is no such basis. Instead, MUS would indicate that the auditor can be 95% confident only that total misstatement does not exceed $475; and that justifiable confidence that total misstatement does not exceed $300 is only 80%—far short of that required.

If two misstatements are selected similar to the one just described, then projected misstatement is $200; the auditor can be 95% confident that total misstatement does not exceed $630; and the justifiable confidence that total misstatement does not exceed $300 is only 58%. For three misstatements, projected misstatement is $300 (the same amount as tolerable misstatement); the auditor can be 95% confident that total misstatement does not exceed $776; and the justifiable confidence that total misstatement does not exceed $300 is only 35%. Or put another way, depending on how large the auditor thinks projected misstatement must be before it is "close to tolerable misstatement", the auditor's justifiable confidence that total misstatement does not exceed tolerable misstatement could approach 35%, an unacceptably low level of confidence by any measure.

If the auditor chooses to use estimated maximum misstatement as described in paragraph A20, then the amounts for 0, 1, 2 and 3 misstatements are $300, $475, $630 and $776 respectively, and the auditor would draw the correct conclusion by comparing those amounts with tolerable misstatement. But the auditor is not obliged to do this and may opt for the "easier" test described in paragraph A19, which, as we have shown, can lead to inappropriate conclusions.

If the sample we have just described was not randomly selected but was otherwise the same, the proposed standard would take the auditor straight to paragraph A19 (paragraph A20 does not apply) and to an evaluation that could be just as misleading, even if not provably so. Thus the evaluation protocol described in paragraph A19 will often lead auditors to believe that they have reduced audit risk to an acceptably low level when in fact they have not.