

## CHAPTER

# 3

# Risk Assessment and Materiality

### ❖ *LEARNING OBJECTIVES*

Upon completion of this chapter you will

- ❖ **LO1** Understand the concept of audit risk.
- ❖ **LO2** Learn the form and components of the audit risk model.
- ❖ **LO3** Understand how to use the audit risk model.
- ❖ **LO4** Learn the limitations of the audit risk model.
- ❖ **LO5** Understand the auditor's risk assessment process.
- ❖ **LO6** Know the factors that determine the auditor's assessment of the risk of material misstatement.
- ❖ **LO7** Learn how to respond to the results of the risk assessments.
- ❖ **LO8** Learn how to evaluate the results of the audit tests.
- ❖ **LO9** Understand the documentation requirements for risk assessments and responses.
- ❖ **LO10** Learn the auditor's communication requirements to management, those charged with governance and others.
- ❖ **LO11** Understand the concept of materiality.
- ❖ **LO12** Know the steps to applying materiality in an audit.
- ❖ **LO13** Apply the materiality steps to an example (EarthWear).
- ❖ **LO14** Understand how to audit accounting estimates, including fair value accounting estimates and related disclosures.

## ❖ RELEVANT ACCOUNTING AND AUDITING PRONOUNCEMENTS

- IASB, IAS 1, Presentation of Financial Statements
- IASB, IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors
- ISA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing
- ISA 240, The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements
- ISA 250, Consideration of Laws and Regulations in an Audit of Financial Statements
- ISA 260, Communication with Those Charged with Governance
- ISA 300, Planning an Audit of Financial Statements
- ISA 315, Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment
- ISA 320, Materiality in Planning and Performing an Audit
- ISA 330, The Auditor's Responses to Assessed Risks
- ISA 450, Evaluation of Misstatements Identified during the Audit
- ISA 500, Audit Evidence
- ISA 530, Audit Sampling
- ISA 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures
- ISA 580, Written Representations
- ISA 700, Forming an Opinion and Reporting on Financial Statements

IN CHAPTER 1 the three fundamental concepts that underlie the conduct of a financial statement audit were briefly discussed. This chapter provides detailed coverage of two of those concepts: **audit risk** and **materiality**. Audit risk and materiality significantly impact the auditor's evidence decisions. The auditor considers both concepts in planning the nature, timing and extent of **audit procedures**, and in evaluating the results of those procedures.

The audit risk model serves as a framework for assessing audit risk. The auditor follows a risk assessment process to identify the risk of material misstatement in the financial statement accounts. The risk of material misstatement is composed of two components of the audit risk model: **inherent risk** and **control risk**. The risk of material misstatement is used to determine the acceptable level of **detection risk** and to plan the auditing procedures to be performed. The auditor restricts audit risk at the account balance level in such a way that, at the end of the engagement, he or she can express an opinion on the financial statements, taken as a whole, at an acceptably low level of audit risk.

In planning the audit the auditor determines materiality for the financial statements as a whole and, if appropriate, materiality for particular classes of transactions, account balances or disclosure. The auditor considers materiality from how **misstatements** could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. Judgements about materiality are made in light of surrounding circumstances, and are affected by the size or nature of a misstatement. In applying materiality on an audit the auditor follows a three-step process.

**Accounting estimates**, including fair value accounting estimates, and related disclosures have become more prevalent in current financial reporting frameworks. The auditor's risk assessment process as well as the evaluation of materiality of misstatements covers accounting estimates. The *Advanced Module* section at the end of this chapter offers a detailed discussion of auditing of accounting estimates.



## AUDIT RISK

LO1

*Audit risk* is the first fundamental concept that underlies the audit process. Because of the nature of audit evidence and the characteristics of management fraud, an auditor can only provide reasonable assurance, as opposed to absolute assurance, that the financial statements are free from material misstatement. The term 'reasonable assurance' is used in the paragraph of the audit report describing the auditor's responsibility to inform the reader that there is some level of risk that the audit did not detect *all* material misstatements. Audit risk is defined as follows:

*Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.*

In simple terms, audit risk is the risk that an auditor will issue an unmodified opinion on materially misstated financial statements. The auditor should perform the audit to reduce audit risk to a sufficiently low level for expressing an opinion on the overall financial statements.

While the auditor is ultimately concerned with audit risk at the financial statement level, as a practical matter audit risk must be considered at more detailed levels through the course of the audit, including the class of transactions, account balance or disclosure level. For ease of presentation, we will use the term *assertion* to refer to consideration of audit risk at these lower levels. In other words, consideration of audit risk at the assertion level means that the auditor must consider the risk that he or she will conclude that an assertion for a particular class of transactions (e.g. classification of capital lease transactions), a particular account balance (e.g. existence of accounts receivable) or a particular disclosure (e.g. valuation of amounts disclosed in a note dealing with stock compensation) is fairly stated, when in fact it is materially misstated.

Thus, at the assertion level, audit risk consists of:

- 1 The risk that the relevant assertions related to classes of transactions, balances or disclosures contain misstatements that could be material to the financial statements when aggregated with misstatements in other classes, balances or disclosures (inherent risk and control risk).
- 2 The risk that the auditor will not detect such misstatements (detection risk).

In other words, audit risk is the combination of these two elements—that the client’s financial statements will contain material misstatements and that the auditor will fail to detect any such misstatements.

In addition to audit risk, an auditor is subject to *business risk* in his or her professional practice, which can be defined as:

**Auditor’s business risk** is the risk that the auditor is exposed to loss or injury to professional practice from litigation, adverse publicity or other events arising in connection with financial statements audited and reported on.

For example, an auditor may conduct an audit in accordance with auditing standards and still be sued by the client or a third party. Although the auditor has complied with professional standards and may ultimately win the lawsuit, his or her professional reputation may be damaged in the process by the negative publicity.

Auditor’s business risk cannot be directly controlled by the auditor, although some control can be exercised through the careful acceptance and continuance of clients. Audit risk, on the other hand, can be directly controlled by manipulating detection risk. The auditor manipulates detection risk by changing the scope of the auditor’s test procedures (see Practice Insight 3.1). As the next section demonstrates, the *audit risk model* provides a framework for auditors to follow in planning audit procedures and evaluating audit results.

### Practice Insight 3.1

When auditors use the term ‘scope’, they are referring to the *nature, timing* and *extent* of audit procedures, where nature refers to the type of evidence; timing refers to when the evidence will be examined; and extent refers to how much of the type of evidence will be gathered.



## THE AUDIT RISK MODEL

LO2

The auditor considers audit risk at the relevant assertion level because this directly assists the auditor to plan the appropriate audit procedures for those transactions, accounts or disclosures. The risk that the relevant assertions are misstated consists of two components:

- 1 *Inherent risk* (IR) is the susceptibility of an assertion about a class of transactions, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls. In other words, IR is the likelihood that a material misstatement exists in the financial statements without the consideration of internal control.
- 2 *Control risk* (CR) is the risk that a misstatement that could occur in an assertion about a class of transactions, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity’s internal control. CR is a function of the effectiveness of the design and operation of internal control in achieving the entity’s objectives relevant to preparation of the entity’s financial statements. Some CR will always exist because of the inherent limitations of internal control.

Inherent risk and control risk exist independently of the audit. In other words, the levels of inherent risk and control risk are functions of the entity and its environment. The auditor has little or no control over these risks. Auditing standards refer to the combination of IR and CR as the *risk of material misstatement* (RMM). Some auditors refer to this combination as ‘client risk’ because it stems from decisions made by the client (e.g. what kinds of business transactions to engage in, how much to invest in internal controls). To properly assess CR, the auditor must understand the client’s controls and perform audit procedures to determine if the controls are operating effectively. You will learn about controls and tests of controls in a financial statement audit in Chapter 6.

*Detection risk* (DR) is the risk that the auditor will not detect a misstatement that exists in a relevant assertion that could be material either individually or when aggregated with other misstatements. Detection risk is determined by the effectiveness of the audit procedure and how well the audit procedure is applied by the auditor. Thus, detection risk cannot be reduced to zero because the auditor seldom examines 100 per cent of the account balance or class of transactions (sampling risk). In addition, the auditor’s work is subject to *non-sampling risk*. Non-sampling risk is the risk that the auditor might select an inappropriate audit procedure, misapply the appropriate audit procedure or misinterpret the audit results. Non-sampling risk can be reduced through adequate planning, proper assignment of audit staff to the engagement team, the application of **professional scepticism**, supervision and review of the audit work performed, and supervision and conduct of a firm’s audit practice in accordance with appropriate quality control standards.<sup>i</sup>

Detection risk has an inverse relationship to inherent risk and control risk. For example, if an auditor judges a client’s inherent risk and control risk to be high, the auditor should set a low level of detection risk in order to achieve the planned level of audit risk. Conversely, if inherent risk and control risk are low, the auditor can accept higher detection risk.

The audit risk model can be specified as:

$$AR = RMM \times DR$$

This model expresses the general relationship of audit risk and the risks associated with the auditor’s assessments of risk of material misstatement (inherent risk and control risk) and the risks that substantive tests will fail to detect a material misstatement in a relevant assertion (detection risk).

The determination of audit risk and the use of the audit risk model involve considerable judgement on the part of the auditor. The audit risk model assists the auditor in determining the scope of auditing procedures for a relevant assertion in a class of transactions, account balance or disclosure. Auditing standards do not provide specific guidance on what is an acceptable low level of audit risk.

The auditor’s assessment of audit risk and its component risks (RMM and DR) is a matter of **professional judgement**. At the completion of the audit, the *actual* or *achieved* level of audit risk is *not* known with certainty by the auditor. If the auditor assesses the *achieved* audit risk as being less than or equal to the *planned* level of audit risk, an unmodified opinion can be issued. If the assessment of the achieved level of audit risk is greater than the planned level, the auditor should either conduct additional audit work or modify the audit opinion. In either case, the judgements involved are often highly subjective.



## Use of the Audit Risk Model

LO3

The audit risk model is not intended to be a precise formula that includes all factors influencing the assessment of audit risk. However, auditors find the logic that underlies the model useful when planning risk levels (and thus making scoping decisions) for audit procedures. The discussion that follows concerning the audit risk model is limited to its use as an audit planning tool. Three steps are involved in the auditor’s use of the audit risk model at the assertion level:

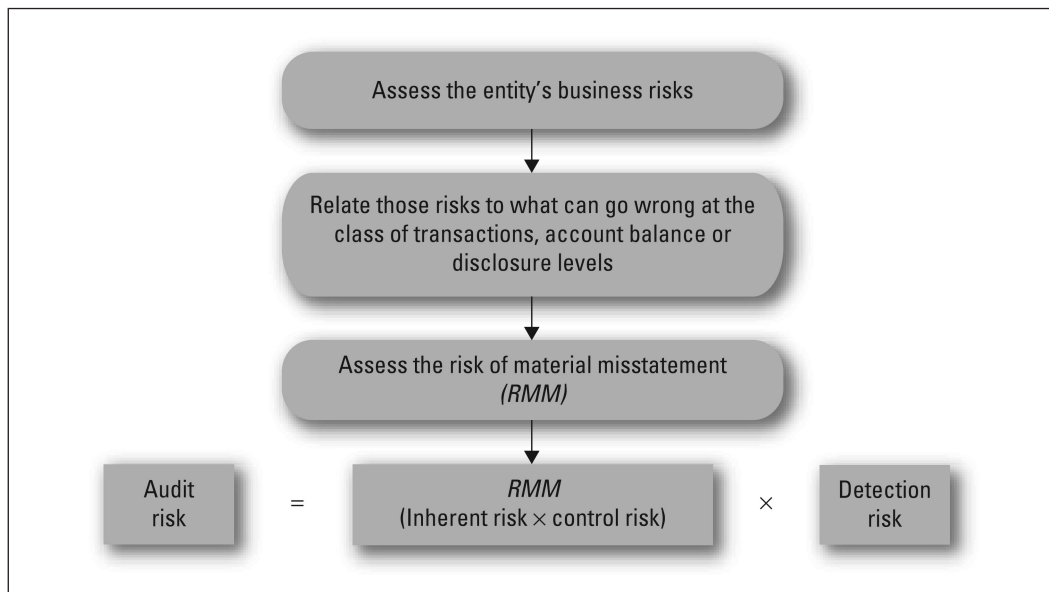
- 1 Setting a planned level of audit risk.
- 2 Assessing the risk of material misstatement.
- 3 Solving the audit risk equation for the appropriate level of detection risk.

### Practice Insight 3.2

Auditing standards allow the auditor to directly assess the *RMM*, or to separately assess the two components of *RMM*, i.e. *IR* and *CR*. This choice is typically built in to each audit firm’s methodology.

In applying the audit risk model in this manner, the auditor determines or assesses each component of the model using either quantitative or qualitative terms. In step 1, the auditor sets audit risk for each class of transactions, account balance or disclosure in such a way that, at the completion of the engagement, an opinion can be issued on the financial statements with an acceptable low level of audit risk. Step 2 requires that the auditor assess the risk of material misstatement (see Practice Insight 3.2). To assess the risk of material misstatement, the auditor evaluates the entity's business risks and how those business risks could lead to material misstatements. Figure 3–1 shows the relationship of the assessment of the entity's business risks and risk of material misstatement to the audit risk model. The assessment of business risks is described in detail in the next two sections of the chapter. In step 3, the auditor determines the appropriate level of detection risk by solving the audit risk model as follows:

$$AR = RMM \times DR$$
$$DR = AR/RMM$$



**Figure 3–1 The Relationship of the Entity's Business Risks to the Audit Risk Model**

The auditor uses the planned level of detection risk to design the audit procedures that will reduce audit risk to an acceptable low level. However, even if the risk of material misstatement is judged to be very low, the auditor must still perform some substantive procedures before concluding that an account balance is not materially misstated. Auditing standards include this caveat because of the imprecision that may occur in assessing the risk of material misstatement.

Consider the following numerical example:

Suppose that the auditor has determined that the planned audit risk for the accounts receivable balance should be set at .05 based on the significance of the account to the financial statements. By establishing a relatively low level of audit risk, the auditor is minimizing the possibility that the account may contain a material misstatement. Assume further that the auditor assesses the risk of material misstatement for accounts receivable to be .60. Substituting the values for AR and RMM into the equation indicates that the auditor should set DR at approximately .08 ( $DR = .05/.60$ ) for testing the accounts receivable balance. Thus, the auditor establishes the **scope of the audit** for accounts receivable so that there is only an 8 per cent chance that a material misstatement, if present, is not detected.

Due to the subjectivity involved in judging the audit risk model's components, many audit firms find it more appropriate to use qualitative terms, rather than percentages, in the model. For example, planned audit risk might be classified into two categories: *very low* and *low*. Auditing standards state that audit risk must be reduced to at least a low level. Likewise, the risk of material misstatement and detection risk might be classified into three categories (e.g. *low*, *moderate* or *high*). The logic behind the audit risk model is the same whether the auditor

uses percentages or qualitative terms. When using qualitative terms, audit risk is set using one of the category choices. Similarly, the auditor selects the category for the risk of material misstatement that is most appropriate under the circumstances. The specified combination of audit risk and risk of material misstatement is then used to determine the appropriate level of detection risk. Following are three examples of the use of a qualitative approach to the audit risk model.

Example	AR	RMM	DR
1	Very low	High	Low
2	Low	Moderate	Moderate
3	Very low	Low	High

In the first example the auditor has determined that a very low level of audit risk is appropriate for this account because of its importance to the financial statement. The auditor has assessed the risk of material misstatement as high, indicating that there is a high risk of a material misstatement that was not prevented, or detected and corrected by the internal control system. Given a very low level of audit risk and a high level of risk of material misstatement, the auditor would set detection risk as low. A low assessment for detection risk implies that the auditor will conduct a more detailed investigation of this account than if the assessment of detection risk were high. Before you continue, think about the other two examples in the chart above. What does the implied DR level mean about how much evidence must be gathered during the audit? Would a lower DR lead you to gather more or less audit evidence?



### Limitations of the Audit Risk Model

LO4

Standard setters developed the audit risk model as a *planning* tool. However, the model has a number of limitations that must be considered by auditors and their firms when the model is used to *revise* an audit plan or to *evaluate* audit results.<sup>11</sup> In those instances, the *actual* or *achieved* level of audit risk may be smaller or greater than the audit risk indicated by the formula. This can occur because the auditor *assesses* the risk of material misstatement, and such an assessment may be higher or lower than the *actual* risk of material misstatement that exists for the client. Inaccurate assessments are likely to result in a flawed determination of detection risk. Thus, the desired level of audit risk may not actually be achieved. In addition, the audit risk model also does not specifically consider non-sampling risk. While the audit risk model has limitations, it serves as an important tool that auditors can use for planning an audit engagement.



### THE AUDITOR'S RISK ASSESSMENT PROCESS

LO5

To properly assess the risks of material misstatement the auditor performs **risk assessment procedures**. The auditor should obtain an understanding of management's objectives and strategies, and the related business risks that may result in material misstatement of the financial statements. The following sections discuss management's strategies, objectives and business risks. We then discuss the auditor's risk assessment process.

### Management's Strategies, Objectives and Business Risks

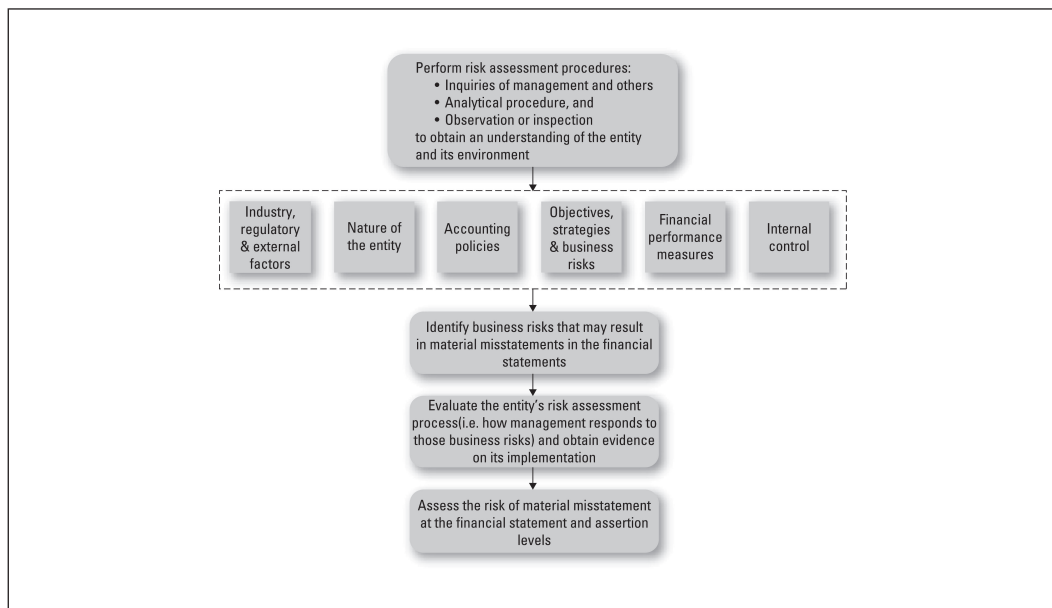
Strategies are the operational approaches used by management to achieve objectives. To achieve their business objectives, managers pursue strategies, such as being the low-cost or high-quality provider of a product. Typical business objectives include growth in market share, first-rate reputation and excellent service. **Business risks** are threats to management's ability to achieve its objectives. Business risks are risks that result from significant conditions, events, circumstances, and actions or inactions that may adversely affect management's ability to execute its strategies and to achieve its objectives, or through the setting of inappropriate objectives or strategies. Business activities, strategies, objectives and the business environment are ever changing, and the dynamic and complex nature of business causes business risks. For example, risks arise from the development of a new product because the product may fail or because flaws in the product may result in lawsuits or damage to the company's reputation. Management is responsible for identifying such risks and responding to them. Usually, management develops approaches to address business risks by implementing a risk assessment process.

## Business Risks and the Risk of Material Misstatement

Business risk is a broader concept than the risk of material misstatement. However, most business risks have the potential to affect the financial statements either immediately or in the long run. Auditors need to identify business risks and understand the potential misstatements that may result. Before you continue, pause and consider how a specific business risk could lead to misstatements in the financial statements. For example, consider a client who sells goods to a declining customer base. What risks does this client face? How will these risks impact the audit? This client faces pressure to maintain historical profit margins, which increases the risk of misstatement associated with the valuation of assets such as receivables. However, the same risk may also have longer-term implications for the company's overall health if the economy remains depressed. In such a case, the auditor would consider the likelihood that the client will not remain financially viable and whether the going-concern assumption is still appropriate.

## Understanding the Entity and Its Environment

Figure 1–2 presented an overview of the audit process. This process starts by obtaining an understanding of the entity and its environment. Obtaining an understanding of the entity and its environment is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. The goal of this step is to assess the business risks faced by the entity. Based on the auditor's understanding of the entity's business risks and how those risks are controlled or not controlled by the entity, the auditor assesses the risk of material misstatement at the assertion level. Figure 3–2 provides an overview of the auditor's assessments of business risks and the risk of material misstatement (i.e. the auditor's risk assessment process). Unless otherwise stated in the text, the risk of material misstatement refers to misstatements caused by **error** or **fraud**.



**Figure 3–2 An Overview of the Auditor's Assessment of Business Risks and the Risk of Material Misstatements**



The auditor's understanding of the entity and its environment includes knowledge about the following categories:

- Industry, regulatory and other external factors.
- Nature of the entity.
- Accounting policies.
- Objectives and strategies, and related business risks.
- Financial performance measures.
- Internal control.

In obtaining knowledge about each of these categories, the auditor should be particularly alert for the following conditions and events that may indicate the existence of business risks:

- Significant changes in the entity such as large acquisitions, reorganizations or other unusual events.
- Significant changes in the industry in which the entity operates.
- Significant new products or services, or significant new lines of business.
- New locations.
- Significant changes in the IT environment.
- Operations in areas with unstable economies.
- High degree of complex regulation.

### *Industry, Regulatory and Other External Factors*

Industry, regulatory and other external factors are relevant to the auditor's understanding of the entity. Obtaining an understanding of these factors assists the auditor in identifying risks of material misstatements. Some industries are subject to risks of material misstatement as a result of unique accounting estimates. For example, a property and casualty insurance company needs to establish loss reserves based on historical data that may be subject to misstatement. Table 3–1 presents examples of industry, regulatory and other external factors that should be considered by the auditor.

Table 3–1 Industry, Regulatory and Other External Factors
<p><b>Industry conditions</b></p> <ul style="list-style-type: none"> <li>● The market and competition, including demand, capacity and price competition.</li> <li>● Cyclical or seasonal activity.</li> <li>● Product technology relating to the entity's products.</li> <li>● Energy supply and cost.</li> </ul> <p><b>Regulatory environment</b></p> <ul style="list-style-type: none"> <li>● Accounting principles and industry-specific practices.</li> <li>● Regulatory framework for a regulated industry.</li> <li>● Legislation and regulation that significantly affect the entity's operations.</li> <li>● Taxation (corporate and other).</li> <li>● Government policies currently affecting the conduct of the entity's business.</li> <li>● Environmental requirements affecting the industry and the entity's business.</li> </ul> <p><b>Other external factors</b></p> <ul style="list-style-type: none"> <li>● General level of economic activity (e.g. recession, growth).</li> <li>● Interest rates and availability of financing.</li> <li>● Inflation and currency revaluation.</li> </ul>

### *Nature of the Entity*

Obtaining an understanding of the nature of the entity includes obtaining an understanding of the following:

- The entity's organizational structure and management personnel.
- The sources of funding of the entity's operations and investment activities, including the entity's capital structure, non-capital funding and other debt instruments.
- The entity's investments.
- The entity's operating characteristics, including its size and complexity.
- The sources of the entity's earnings, including the relative profitability of key products and services.
- Key supplier and customer relationships.



- Financial reporting, including accounting for fair values.

An understanding of the nature of an entity gives the auditor a better idea of what potential misstatements might be found in the financial statements. For example, the applicable financial reporting framework may require or permit a variety of fair value measurements and disclosures. To assess the risk of material misstatement the auditor should understand the requirements of the reporting framework relevant to fair value accounting. Take a moment to think about the importance of fair values in current financial reporting frameworks, and how fair value measurements may involve estimation uncertainty and give rise to risk of material misstatement.

### Practice Insight 3.3

Auditors are expected to understand the accounting principles and rules relating to accounting on the basis of fair value, including disclosures, and to give appropriate consideration to the audit of fair values. Auditing of fair values may be particularly challenging in times of market uncertainty and illiquid markets.

### Accounting Policies

The auditor should evaluate whether the entity's **accounting policies** are appropriate for the business, and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry. For example, the auditors evaluate if EarthWear's policy to capitalize and amortize cost of direct-response advertising such as catalogue production is consistent with the requirements in the financial reporting framework and industry norms. An understanding of the entity's selection and application of accounting policies may encompass such matters as:

- The methods the entity uses to account for significant and unusual transactions.
- The entity's revenue recognition policies.
- The effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.
- Changes in the entity's accounting policies.
- Financial reporting standards and laws and regulations that are new to the entity, and when and how the entity will adopt such requirements.

The fact that an audit covers accounting policies and accounting estimates is expressed to users of the financial statements by the sentence, 'An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements', contained in the auditor responsibility paragraph of the auditor's report (refer to Exhibit 1–1).

### Objectives, Strategies and Related Business Risks

As discussed previously, the auditor must identify and understand the entity's objectives and strategies used to achieve its objectives, and the business risks associated with those objectives and strategies. Table 3–2 provides examples of business risks the auditor considers when developing an understanding of the entity's objectives and strategies.

**Table 3–2 Examples of Business Risks that the Auditor Considers When Developing an Understanding of the Entity's Objectives and Strategies**

- Industry developments.
- New products and services.
- Expansion of the business.
- New accounting requirements.
- Regulatory requirements.
- Current and prospective financing requirements.
- Use of IT.
- Effects of implementing a strategy, particularly any effects that will lead to new accounting requirements.

Smaller entities often do not set their objectives and strategies, or manage the related business risks, through formal plans or processes. In many cases there may be no documentation of such matters. In such entities the auditor's understanding is ordinarily obtained through inquiries of management and observation of how the entity responds to such matters.

### *Financial Performance Measures*

Internally generated information used by management to measure and review the entity's financial performance may include:

- Key performance indicators (KPIs).
- Budgets.
- Variance analysis.
- Subsidiary information and divisional, departmental or other level performance reports.
- Comparisons of an entity's performance with that of competitors.

External parties (e.g. analysts and credit rating agencies) may also measure and review the entity's financial performance. Internal measures provide management with information about progress towards meeting the entity's objectives. Thus, a deviation in the entity's performance measures may indicate a risk of misstatement in the related financial statement information. When the auditor intends to make use of the entity's performance measures for the purpose of the audit, the auditor should consider whether the information provided is reliable and trustworthy, and whether it is sufficiently detailed or precise. Both internal and external information is useful to the auditor's understanding of the entity and its environment.

Smaller entities ordinarily do not have formal processes to measure and review the entity's financial performance. Management nevertheless often relies on certain key indicators which knowledge and experience of the business suggest are reliable bases for evaluating financial performance and taking appropriate action.

### *Internal Control*

Internal control is the label given to the entity's policies and procedures designed to provide reasonable assurance about the achievement of the entity's objectives. Internal control is implemented by the client's board of directors (or other body charged with governance), management and other personnel. Because of the significance of internal control to the financial statement audit, it will be covered in great detail in Chapter 6. To provide you with an introduction to the concept of internal control, here are several examples of policies and procedures that may be a part of an entity's internal control:

- Active and qualified board of directors and audit committee with members independent from the company.
- Effective risk assessment process.
- Competent and objective internal audit personnel.
- Proper authorization of transactions (e.g. a supervisor must approve all purchases over €5,000).
- Procedures to ensure assets exist (e.g. inventory counts).
- Monitoring of controls (e.g. supervisor observes the procedures at the loading dock to ensure control procedures are properly followed).

The auditor should understand and assess the effectiveness of internal control. The auditor uses the understanding of internal control to identify types of potential misstatements; consider factors that affect the risks of material misstatement; and design appropriate audit procedures.

## **Auditor's Risk Assessment Procedures**

The auditor obtains an understanding of the entity and its environment by performing the following risk assessment procedures: inquiries of management and others; analytical procedures; and observation and inspection.

### *Inquiries of Management and Others*

The auditor obtains information about the entity and its environment through inquiry of management, individuals responsible for financial reporting and other personnel within the entity. For example, the

auditor makes inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates. As another example, the auditor inquires of management about the entity's related parties and related party transactions. Making inquiries of others *within* the entity may be useful in providing the auditor with a perspective different from that of management and those responsible for financial reporting. The auditor might make inquiries of:

- The board of directors, audit committee or others charged with governance.
- Internal audit personnel.
- Employees involved in initiating, processing or recording complex or unusual transactions.
- In-house legal counsel.
- Production, marketing, sales and other personnel.

For example, inquiries directed to internal audit personnel might relate to their activities concerning the design and operating effectiveness of the entity's internal controls. The auditor might also inquire of the in-house legal counsel about issues such as litigation, compliance with laws and regulations, and the meaning of contract terms.

The auditor might also inquire of others *outside* the entity. For example, the auditor may consider it is appropriate to make inquiries of customers, suppliers or valuation experts. Such discussions may provide information that will assist the auditor in uncovering the fraud. For example, customers may report that they received large quantities of unordered products from the audit client just before year end. This would be an indicator of overstated revenues.

### *Analytical Procedures*

**Analytical procedures** are evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Auditing standards require that the auditor conducts analytical procedures in planning the audit. Such preliminary analytical procedures assist the auditor in understanding the entity and its environment, and in identifying areas that may represent specific risks relevant to the audit. Analytical procedures can be helpful in identifying the existence of unusual transactions or events and amounts, ratios and trends that might have implications for audit planning. In performing such analytical procedures, the auditor should develop expectations about plausible relationships that are expected to exist, based on the understanding of the entity and its environment. However, the results of such high-level analytical procedures provide only a broad initial indication about whether a material misstatement may exist. Analytical procedures are discussed in more detail in Chapter 5.

### *Observation and Inspection*

Observation and inspection include audit procedures such as:

- Observation of entity activities and operations.
- Inspection of documents (e.g. business plans and strategies), records and internal control manuals.
- Reading reports prepared by management, those charged with governance, and internal audit.
- Visits to the entity's premises and plant facilities.
- Tracing transactions through the information system relevant to financial reporting, which may be performed as part of a walk-through.

The auditor may also read about industry developments and trends, read the current year's interim financial statements, and review regulatory or financial publications. Table 3–3 presents sources where the auditor can obtain information for developing an understanding of the entity and its environment.

**Table 3–3 Sources of Information for Understanding the Entity and Its Environment**

- Cumulative knowledge and experience obtained from prior audits.
- Procedures performed in client acceptance and continuance process.
- Knowledge obtained from performing interim procedures.
- Consulting, tax or other engagements performed for the entity.
- Communications with predecessor auditors.
- Published annual reports and interim reports to shareholders, if applicable.
- Discussions with management.
- Minutes of board of director's and/or audit committee's meetings.
- Entity's business/strategic plans, budgets or other documentation.
- Reports prepared by analysts, banks, underwriters, rating agencies and the like.
- Individuals knowledgeable about the industry, such as the engagement team members for clients in a similar business/industry.
- Audit firm – generated industry guidance, databases and practice aids, where applicable.
- Government statistics.
- Economic and financial journals.
- Industry or trade journals.
- Client press releases, publications and brochures.
- Internal audit reports.

## EVALUATE THE ENTITY'S RISK ASSESSMENT PROCESS

Management has a responsibility to identify, control and mitigate business risks that may affect the entity's ability to achieve its objectives. The auditor should obtain information on the entity's risk assessment process and whether it is operating effectively. If the entity's response to the identified risk is adequate, the risk of material misstatement may be reduced. However, if the entity's response to the identified risk is inadequate, the auditor's assessment of the risk of material misstatement may increase. If the entity does not respond adequately to business risks, the auditor will have to develop tests to determine if any misstatements are present in the related class of transactions or account balance. Chapter 6 provides detailed coverage of the entity's risk assessment management process.



LO6

## ASSESSING THE RISK OF MATERIAL MISSTATEMENT DUE TO ERROR OR FRAUD<sup>III</sup>

Based on knowledge of the entity and its environment, the auditor should assess the risk of material misstatement at the assertion level and determine the audit procedures that are necessary based on that **risk assessment** (see Fig. 3–2). At this point in the risk assessment process, the auditor has identified the entity's business risks. To assess the risk of material misstatement, the auditor must then consider how the identified risks could result in a material misstatement in the financial statements. This includes considering whether the magnitude and likelihood of the risk could result in a material misstatement. For example, the entity's risk assessment process may have identified product obsolescence as a business risk that could result in a material misstatement to the inventory and cost-of-goods accounts. However, the entity's risk assessment process has determined that there is a low likelihood that such a misstatement could occur because the entity has installed strong controls that track inventory levels and market pricing.

This section will first review the types and causes of misstatements, and then focuses primarily on assessing the risk of material misstatement due to fraud, sometimes referred to as the *fraud risk assessment*.

## Types and Causes of Misstatements<sup>iv</sup>

Misstatements can result from error or fraud. The term *error* refers to *unintentional* misstatements of amounts or disclosures in financial statements. The term *fraud* refers to an *intentional* act by one or more individuals among management, those charged with governance, employees or third parties, involving the use of deception to obtain an unjust or illegal advantage. Thus, the primary distinction between error and fraud is whether the misstatement was intentional or unintentional. Unfortunately, it is often difficult to determine intent. For example, suppose the auditor detects a misstatement in an account that requires an estimate, such as bad debt expense; it may be difficult to determine whether the misstatement was intentional.

A misstatement due to error or fraud is defined as follows:

**A misstatement due to error or fraud is a difference between the amount, classification, or presentation of a reported financial statement element, account or item and the amount, classification or presentation that would have been reported under the applicable financial reporting framework.**

Misstatements from error and fraud may result from:

- An inaccuracy in gathering or processing data from which the financial statements are prepared.
- An omission of an amount or disclosure.
- An incorrect accounting estimate arising from overlooking or clear misinterpretation of facts.
- Management's selection and application of accounting policies that the auditor considers inappropriate or judgements concerning accounting estimates that the auditor considers unreasonable, including related disclosures.

*Fraud* can be classified into two types: (1) misstatements arising from fraudulent financial reporting; and (2) misstatements arising from misappropriation of assets.

Misstatements arising from fraudulent financial reporting are intentional misstatements or omissions of amounts or disclosures in financial statements intended to deceive financial statement users. Fraudulent financial reporting may involve acts such as the following:

- Manipulation, falsification or alteration of accounting records or supporting documents from which financial statements are prepared.
- Misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant information.
- Intentional misapplication of accounting policies relating to amounts, classification, manner of presentation or disclosure.

Misstatements arising from misappropriation of assets (sometimes referred to as *defalcation*) involve the theft of an entity's assets where the theft causes the financial statements to be misstated. Examples of misappropriation include:

- Embezzling cash received.
- Stealing assets.
- Causing the entity to pay for goods or services not received.

Misappropriation of assets may be accompanied by false or misleading records or documents, possibly created by circumventing controls, and may involve one or more individuals among management, employees or third parties.

To assist the auditor in evaluating misstatements identified during the audit auditing standards distinguish between **factual misstatements**, **judgemental misstatements** and **projected misstatements**:

- Factual misstatements are misstatements about which there is no doubt.
- Judgemental misstatements are differences arising from the selection or application of accounting policies that the auditor considers inappropriate, or the judgements of management concerning accounting estimates that the auditor considers unreasonable.
- Projected misstatements are the auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn (see Chapter 9).

## The Fraud Risk Identification Process

The auditor performs the following steps to obtain information to identify the risks of material misstatement due to fraud:

- Discussion among the audit engagement members regarding the risks of material misstatement due to fraud.
- Inquire of management, those charged with governance and others about their views on the risks of fraud and how it is addressed.
- Consider any unusual or unexpected relationships that have been identified in performing analytical procedures in planning the audit, including procedures related to revenue accounts.

The following two sections address the first two points.

### *Discussion among the Audit Engagement Team*

Auditing standards (ISA 240 and ISA 315) require that the engagement team have discussions about the entity's financial statements' susceptibility to material misstatements. In planning the audit, the engagement partner or manager should communicate with members of the engagement team regarding the potential for material misstatement due to fraud. This brainstorming session can be held separately, or concurrently, with the discussion required as part of understanding the entity and its environment (ISA 315, para. 10). The engagement partner or manager should determine which audit engagement members should be included in the communication, how it should occur and the extent of the communication. The objectives of the brainstorming meeting are to:

- Share insights about the entity and its environment, and the entity's business risks.
- Provide an opportunity for the team members to discuss how and where the entity might be susceptible to fraud.
- Emphasize the importance of maintaining professional scepticism throughout the audit regarding the potential for material misstatement due to fraud.

Engagement team members should be encouraged to communicate and share information obtained throughout the audit that may affect the assessment of risks of material misstatement or the auditor's responses to those risks. Small audits are often carried out entirely by the engagement partner. In such situations, the engagement partner, having personally conducted the planning of the audit, considers the susceptibility of the entity's financial statements to material misstatement due to fraud.

The auditor should conduct the audit with professional scepticism. Professional scepticism includes a questioning mind and a critical assessment of audit evidence. For example, the auditor should be alert to audit evidence that contradicts other audit evidence obtained and information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence. The auditor should conduct the engagement assuming there is a possibility that a material misstatement due to fraud could be present, regardless of any prior beliefs or past experience with the entity and regardless of the auditor's belief about management's honesty and integrity. Pretend for a moment that you are a member of the engagement team assigned to the EarthWear audit and are thus participating in the fraud brainstorming session concerning EarthWear. What are one or two of the external/internal influences that might create pressure for EarthWear to commit fraud? (See Table 3–4.)

### *Inquiries of Management and Others*

The auditor should inquire about management's knowledge of fraud within the entity. The auditor should also understand the programmes and controls that management has established to mitigate specific risk factors and how well management monitors those programmes and controls. Some of the inquiry would take place when the auditor obtains an understanding of the entity and its environment.

Those charged with governance in the entity, such as the board of directors, the audit committee or other body with equivalent authority and responsibility should assume an active role in oversight of the assessment of the risk of fraud. The auditor should obtain an understanding of how the board of directors exercises its oversight activities, including direct inquiry of the board of directors. When the entity has an internal audit function, the auditor also should inquire of internal audit personnel about their assessment of the risk of fraud, including whether management has satisfactorily responded to internal audit findings during the year.



The auditor should also consider inquiries from others within the entity and third parties. For example, the auditor also may consider making inquiries of third parties, such as vendors, customers or regulators. It can be uncomfortable to inquire about potentially fraudulent activities; however, it is much more uncomfortable to fail to detect a material fraud.

### Conditions Indicative of Fraud and Fraud Risk Factors

Three conditions are generally present when material misstatements due to fraud occur:

- 1 Management or other employees have an *incentive* or are under *pressure* that provides a reason to commit fraud.
- 2 Circumstances exist that provide an *opportunity* for a fraud to be carried out.
- 3 Those involved are able to *rationalize* committing a fraudulent act. Some individuals possess an *attitude*, character or set of ethical values that allow them to knowingly and intentionally commit a dishonest act.

These three conditions are sometimes referred to as the fraud risk triangle. Even honest individuals can commit fraud in an environment where sufficient pressure is being exerted on them. The greater the incentive or pressure, the more likely an individual will be able to rationalize the acceptability of committing fraud. Withholding evidence or misrepresenting information through falsified documentation, including forgery, may conceal fraud. Fraud also may be concealed through collusion among management, employees or third parties.

Management has the ability to perpetrate fraud because it is in a position to directly or indirectly manipulate the accounting records and prepare fraudulent financial reports. In most cases, fraudulent financial reporting also involves some management override of controls.

Because of the characteristics of fraud, particularly those involving concealment through collusion; withheld, misrepresented or falsified documentation; and the ability of management to override or instruct others to override controls, an auditor may unknowingly rely on audit evidence that appears to be valid, but in fact is false and fraudulent.

Thus, **fraud risk factors** related to fraudulent financial reporting and misappropriation of assets can be classified among the three conditions generally present when fraud exists:

- An *incentive/pressure* to perpetrate fraud.
- An *opportunity* to carry out the fraud.
- An *attitude/rationalization* to justify the fraudulent action.

### Fraudulent Financial Reporting

Tables 3–4 to 3–6 present the risk factors related to each category of conditions for the potential for fraudulent financial reporting. Table 3–4 contains numerous risk factors that, if present, may suggest that management and others have incentives to manipulate financial reporting. For example, the entity may be facing increased competition that results in declining profit margins. Similarly, in the high-technology sector, rapid changes in technology can affect the profitability and the fair market value of products. Entities that have recurring operating losses and negative cash flow from operations may face bankruptcy, foreclosure or takeover. In each of these situations, management may have incentives to manipulate reported earnings. Management (or those charged with governance) may also be facing pressures to maintain the entity's reported earnings to meet analysts' forecasts because their bonuses or personal wealth are tied to the entity's stock price. Exhibit 3–1 illustrates the massive fraudulent financial reporting in Satyam Computer Services Limited – India's Enron.

**Table 3–4 Risk Factors Relating to Incentives/Pressures to Report Fraudulently**

- Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as:
  - High degree of competition or market saturation, accompanied by declining margins.
  - High vulnerability to rapid changes, such as changes in technology, product obsolescence or interest rates.
  - Significant declines in customer demand and increasing business failures in either the industry or overall economy.
  - Operating losses making the threat of bankruptcy, foreclosure or hostile takeover imminent.
  - Rapid growth or unusual profitability, especially compared with that of other companies in the same industry.
  - New accounting, statutory or regulatory requirements.



- Excessive pressure exists for management to meet requirements or expectations of third parties due to:
  - Profitability or trend level expectations of investment analysts, institutional investors, significant creditors or other external parties.
  - Need to obtain additional debt or equity financing to stay competitive.
- The personal financial situation of management or those charged with governance is threatened by the entity's financial performance.

#### Exhibit 3–1 Satyam Computer Services Limited – India's Enron

On 7 January 2009, B. Ramalinga Raju, Chairman and Founder of Satyam, sent a letter to the Board of Directors informing them that he had carried out a massive financial statement fraud. In his letter, Raju stated that the fraud 'attained unmanageable proportions as the size of the company operations grew'. Satyam was India's fourth largest technology company. Its stock traded on the NYSE and it was audited by Price Waterhouse, a separate legal entity within the PricewaterhouseCoopers global business network. Some of the companies for which Satyam does outsourcing work include Citicorp, Caterpillar and Coca-Cola. Ironically, Satyam means 'truth' in Sanskrit.

For the year ended 31 March 2008, Satyam reported sales of \$2.1 billion and profits of \$427.6 million. However, Mr Raju's letter indicated that in the quarter ended 30 September 2008, Satyam reported \$555 million in sales instead of the true figure of \$434 million. The company reported \$136 million in profit, but the real amount was \$12.5 million. Accounts receivable were reported at \$545.6 million but Mr Raju indicated in reality they totalled only \$444.8 million. Most importantly, Satyam reported \$1.1 billion in available cash, but had only \$66 million on hand. More than \$1 billion of Satyam's cash was either missing or never existed!

The Indian government ousted the Board of Directors and Price Waterhouse was removed as the company's auditors. KPMG and Deloitte were hired as the new auditors.

Investigators determined that Satyam's account-balance statements and letters of confirmation of account balances at HSBC Holdings PLC of the UK, Citigroup Inc. of the US, and HDFC Bank and ICICI Bank Ltd. of India were forgeries.

*Selected sources:* B.R. Raju, Letter to Satyam's Board of Directors (7 January 2009); 'India's Enron: Scandal hits India's flagship industry', *The Economist* (8 January 2009); 'Pricewaterhouse Defends Its Audit Procedures', *Wall Street Journal* (9 January 2009); 'The Satyam Scandal: Offshore Inmates' – India Struggles to Get to Grips with a Bewildering Corporate Fraud', *The Economist* (15 January 2009); 'Satyam Bank Documents at Issue', *Wall Street Journal* (20 January 2009); and 'Satyam Founder Accused of Falsely Inflating Size of Staff', *Wall Street Journal* (23 January 2009).

Management must also have the opportunity to commit the fraud. Table 3–5 lists the opportunities that may be available to management or those charged with governance to perpetuate fraudulent financial reporting. For example, assets, liabilities, revenues or expenses may be based on subjective estimates that may be difficult for the auditor to corroborate. Two examples of such situations are the recognition of income on long-term contracts when the percentage of completion method is used, and establishing the amount of loan loss reserves for a financial institution. Another opportunity for fraudulent financial reporting is when a single person or small group dominates management. Dominance by one individual may lead to processing accounting transactions that are not consistent with the entity's controls.

**Table 3–5 Risk Factors Relating to Opportunities to Report Fraudulently**

- The nature of the industry or the entity's operations provide opportunities to engage in fraudulent financial reporting due to:
  - Significant related-party transactions.
  - Assets, liabilities, revenue, or expenses based on significant estimates that involve subjective judgements or uncertainties that are difficult to corroborate.
  - Significant, unusual or highly complex transactions.
- There is ineffective monitoring of management.
- There is a complex or unstable organizational structure.
- Internal control components are deficient.

Risk factors reflective of attitudes/rationalizations by board members or others charged with governance, management or employees may allow them to engage in and/or justify fraudulent financial reporting. Table 3–6 lists a number of attitudes or rationalizations that may be used to justify fraudulent financial reporting. For example, the entity may have weak ethical standards for management behaviour or poor communication channels for reporting such behaviour.

**Table 3–6 Risk Factors Relating to Attitudes/Rationalizations to Report Fraudulently**

- Ineffective communication implementation, support and enforcement of the entity's values or ethical standards by management, or the communication of inappropriate values or ethical standards.
- Non-financial management's excessive participation in, or preoccupation with, the selection of accounting policies or the determination of significant estimates.
- Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or those charged with governance alleging fraud or violations of laws and regulations.
- Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend.
- A practice by management of committing to analysts, creditors and other third parties to achieve aggressive or unrealistic forecasts.
- Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality.

### *Misappropriation of Assets*

Risk factors that relate to misstatements arising from misappropriation of assets also are classified along the three conditions generally present when fraud exists. Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present when misstatements arising from misappropriation of assets exist (see Exhibit 3–2). Table 3–7 presents the risk factors related to each category of conditions for the potential of misappropriation of assets. For example, an employee may have financial problems that create an incentive to misappropriate the cash. In order for the employee who has financial problems to misappropriate cash, he or she must have access to the cash. This is likely to occur only when there is inadequate segregation of duties or poor oversight by personnel responsible for the asset. Lastly, an employee who has access to assets susceptible to misappropriation may have a change in behaviour or lifestyle that may indicate he or she has misappropriated assets.

**Table 3–7 Risk Factors Relating to the Misappropriation of Assets**

#### **Incentive/Pressures**

- Personal financial obligations may create pressure for management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.
- Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets.

#### **Opportunities**

- Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, large amounts of cash on hand or processed.
- Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may exist because there is inadequate management oversight of employees responsible for assets.

#### **Attitudes/Rationalization**

- Disregard for the need for monitoring or reducing risks related to misappropriation of assets.
- Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to correct known internal control deficiencies.
- Changes in behaviour or lifestyle that may indicate assets have been misappropriated.

Exhibit 3–2 illustrates a misappropriation of assets of historical dimensions: the Madoff \$50 billion fraud.

### Exhibit 3–2 Madoff 's \$50 Billion Ponzi Scheme

In early December 2008, Bernie Madoff told his two sons that his investment advisory business, Bernard Madoff Investment Securities (BMIS), was basically a giant Ponzi scheme. Madoff had falsely represented to investors that returns were being earned on their accounts at BMIS and that he was investing their money in securities. In fact, Madoff paid earlier investors with funds raised from later investors. Authorities believe that the fraud may date back at least three decades. Madoff estimated the losses from the fraud at as much as \$50 billion. Madoff's investors included many famous individuals and charities, some of whom lost their life savings.

While Madoff told prosecutors that he had acted alone, one of the major issues is how much others may have been involved. Others include the value of any remaining assets in BMIS, whether Madoff hid some of the assets, and how much of his personal assets can be used to pay off investors.

*Selected sources:* Securities and Exchange Commission Complaint, United States District Court Southern District Of New York (11 December 2008); 'US: Madoff had \$173 Million in Checks', *Wall Street Journal* (9 January 2009); 'Madoff Brother, at Arm's Length?', *Wall Street Journal* (10–11 January 2009); 'Sons' Roles in Spotlight', *Wall Street Journal* (24–25 January 2009); 'The Madoff Affair: Going Down Quietly – History's Biggest Swindler Faces Life Behind Bars But Keeps Mum', *The Economist* (12 March 2009).

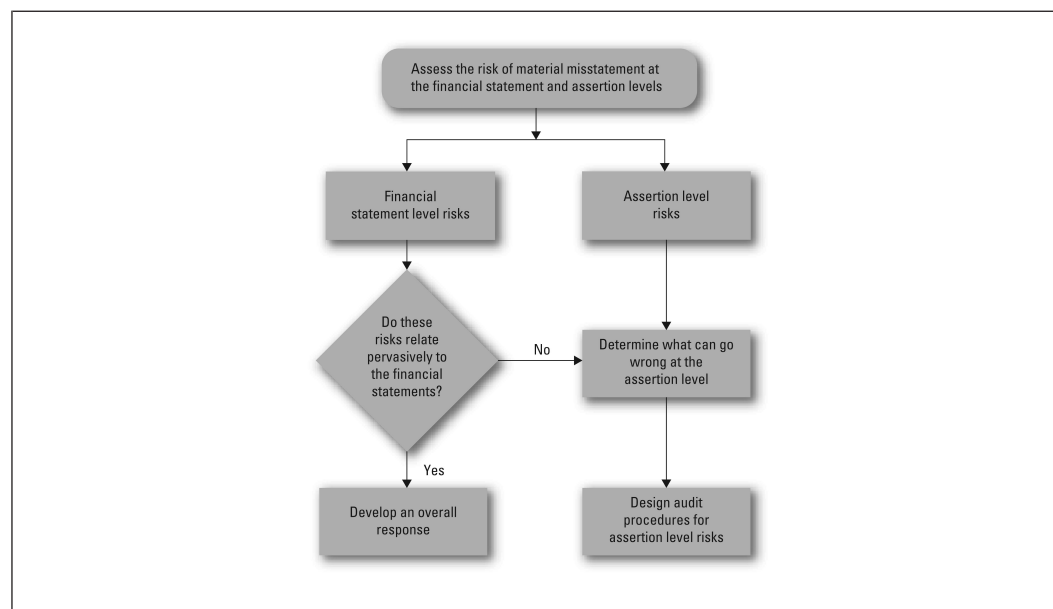


LO7

## THE AUDITOR'S RESPONSE TO THE RESULTS OF THE RISK ASSESSMENTS

Figure 3–3 provides an overview of how the auditor responds to the results of the risk assessments. Once the risks of material misstatement have been identified, the auditor determines whether they relate more pervasively to the overall financial statements and potentially affect many relevant assertions or whether the identified risks relate to specific relevant assertions, related to classes of transactions, account balances and disclosures. To respond appropriately to financial statement level risks, the auditor's response may be a reconsideration of the overall audit approach. The response to such pervasive risks may include:

- Emphasizing to the engagement team the need to maintain professional scepticism in gathering and evaluating audit evidence.
- Assigning more experienced staff or those with specialized skills, or using experts.
- Providing more supervision.
- Incorporating additional elements of unpredictability in the selection of audit procedures to be performed.



**Figure 3–3 Relating the Assessment of the Risk of Material Misstatement to the Design and Performance of Audit Procedures**

When the risks relate to a single assertion or set of assertions for the same business process or account, the auditor should consider the entity's internal controls. As discussed in Chapter 6, the auditor needs to consider the design and operation of controls within a business process to determine if they prevent, or detect and correct misstatements. If the controls are properly designed, and the auditor intends to rely on those controls, the auditor will test the operating effectiveness of the controls. Depending on the operating effectiveness of the entity's controls, the auditor will design and perform substantive tests directed at the potential misstatements that may result from the identified risks.

As part of the risk assessment process, the auditor should determine which of the risks identified require special audit consideration. Such risks are referred to as **significant risks** (ISA 315, paras 27–29). The auditor uses professional judgement to determine which risks are significant, and uses that judgement to determine whether the nature of the risk, the likely magnitude of the potential misstatement including the possibility that the risk may give rise to multiple misstatements, and the likelihood of the risk occurring are such that they require special audit consideration. Examples of the types of items that may result in significant risks include:

- Assertions identified with fraud risk factors.
- Non-routine or unsystematically processed transactions.
- Significant accounting estimates and judgements.
- Highly complex transactions.
- Significant transactions with related parties.
- Significant transactions outside the normal course of business of the entity, or that otherwise appear to be unusual.
- Application of new accounting standards.
- Revenue recognition in certain industries or for certain types of transactions.
- Industry-specific issues.

The auditor always treats assessed risks of material misstatement due to fraud as significant risks (ISA 240 para. 27). Accounting estimates having high estimation uncertainty such as estimates highly dependent upon judgement give rise to significant risks. (The section on the *Advanced Module* later in this chapter discusses auditing of accounting estimates in detail.)

When the auditor has determined that a significant risk exists, the auditor should, to the extent not already done, obtain an understanding of the entity's controls, including control activities, *relevant to that risk* (ISA 315 para. 29). The auditor should always perform substantive procedures that *directly respond* to the significant risk at assertion (ISA 330 para. 21). For example, for accounting estimates that give rise to significant risks the auditor should perform specific substantive procedures including evaluation of the reasonableness of management's assumptions and how estimation uncertainty has been addressed. When the auditor plans to rely on controls over a significant risk, the auditor tests those controls in the current period (ISA 330 para. 15).

### Practice Insight 3.4

Auditing standards state that the auditor should presume that there is a fraud risk involving improper revenue recognition on every audit engagement. The auditor must evaluate the types of revenue or revenue transactions that are subject to such a risk.

**LO8**

## EVALUATION OF AUDIT TEST RESULTS

As the audit progresses and at the completion of the audit the auditor evaluates the effect of the identified misstatements on the audit. The auditor requests, on a timely basis, management to correct misstatements. At the completion of the audit the auditor determines if the remaining uncorrected misstatements would cause the financial statements to be materially misstated. If the individual or aggregate uncorrected misstatements are greater than materiality, the auditor would have to issue a qualified or adverse opinion. When the uncorrected misstatements are evaluated immaterial and the relevant qualitative aspects of the entity's accounting practices and financial statements presentation do not imply otherwise, the auditor can conclude that the financial statements as a whole are free from material misstatement. (Chapter 18 discusses in detail the auditor's forming of an audit opinion, including evaluations related to relevant qualitative aspects of the entity's accounting practices and financial statements.)

If the auditor has determined that the misstatement is or may be the result of fraud, and either has determined that the effect could be material to the financial statements or has been unable to evaluate whether the effect is material, the auditor should:

- Attempt to obtain audit evidence to determine whether, in fact, material fraud has occurred and, if so, its effect.
- Consider the implications for other aspects of the audit.
- Discuss the matter and the approach to further investigation with an appropriate level of management that is at least one level above those involved in committing the fraud and with senior management.
- If appropriate, suggest that the client consult with legal counsel.

If the results of the audit tests indicate a significant risk of fraud, the auditor should consider withdrawing from the engagement and communicating the reasons for withdrawal to those charged with governance (i.e. the board of directors, the audit committee or others with equivalent authority and responsibility).



LO9

## DOCUMENTATION OF THE AUDITOR'S RISK ASSESSMENT AND RESPONSE

The auditor has extensive documentation requirements for risk assessment (including fraud risk assessment) and audit responses to identified risks. For example, the auditor should document the risk of material misstatement for all material accounts and classes of transactions in terms of the related assertions. The level of risk may be described as quantitative or qualitative (high, medium or low). Exhibit 3–3 shows the use of a questionnaire to document the nature of the entity. Briefly review this exhibit. After considering the responses listed on the document, how would this information guide the planning of your audit? Other areas of documentation include the following:

- The nature and results of the communication among engagement personnel that occurred in planning the audit regarding the risks of material misstatement.
- The steps performed in obtaining knowledge about the entity's business and its environment. The documentation should include:
  - The risks identified.
  - An evaluation of management's response to such risks.
  - The auditor's assessment of the risk of error or fraud after considering the entity's response.
- The nature, timing and extent of the procedures performed in response to the risks of material misstatement due to fraud and the results of that work.
- Fraud risks or other conditions that caused the auditor to believe that additional audit procedures or other responses were required to address such risks or other conditions.
- The nature of the communications about fraud made to management, those charged with governance, and others.
- The basis for the auditor's conclusions about the reasonableness of accounting estimates that give rise to significant risks.

**Exhibit 3–3 A Partial Questionnaire for Documenting the Understanding of EarthWear Clothiers and its Environment**

<b>CLIENT NAME: EARTHWEAR CLOTHIERS</b>		<b>Completed by:</b>
<b>Entity and Environment Category: Nature of the Entity</b>		<b>Reviewed by:</b>
<b>Year ended: 31 December 2009</b>		
<i>Risk Factors</i>	<i>Description/Response</i>	<i>Any Remaining Risk</i>
What are the entity's major sources of revenue, including the nature of its products and or services?	<p>EarthWear Clothiers generates revenue mainly through the sale of high-quality clothing for outdoor sports, such as hiking, skiing, fly-fishing and white-water kayaking. The company's product lines also include casual clothes, accessories, shoes and soft luggage.</p> <p>These sales are made mainly through the company's freephone number and over its Internet websites. In 2009, Internet sales accounted for 21 per cent of total revenue.</p>	No. The company uses conservative methods to record revenue and provides an adequate reserve for returned merchandise.

Who are the entity's key customers?	The company's key customers are the 21.1 million persons on its mailing list, approximately 7 million of whom are viewed as 'current customers' because they have purchased from the company in the last 24 months. Market research as of January 2008 indicates that approximately 50 per cent of customers are in the 35–54 age group and had a median income of €62,000. Almost two-thirds are in professional or managerial positions.	No.
Who are the entity's key suppliers?	During 2009, the company had purchase orders for merchandise from about 300 domestic and foreign manufacturers, including intermediaries (agents). One manufacturer and one intermediary accounted for about 14 and 29 per cent of the company's received merchandise euros, respectively, in 2009. In 2009, about 80 per cent of the merchandise was imported, mainly from Asia. The company will continue to take advantage of worldwide sourcing without sacrificing customer service or quality standards.	Yes. The company would be subject to some risk in finding alternative sourcing if this manufacturer and or intermediary experiences prolonged work stoppages or economic problems. The availability and cost of certain foreign products may be affected by trade policies, economic events and the value of the euro relative to other currencies.
What is the entity's organizational structure?	The company has a well-developed organizational structure with clear lines of authority among the various operating departments and staff functions. The organizational structure is appropriate for EarthWear's activities.	No.
Where are its major locations?	Europolis is the main corporate location. EarthWear has its main international phone centre in Mumbai. Other centres are in the UK, Germany and Japan. During 2009, EarthWear expanded its global Internet presence by launching sites in ten more countries.	Yes. The USA and Italy have restrictive trade laws where companies get a certain degree of protection from the government when their markets are threatened. Political uncertainty in less developed countries could affect EarthWear's sales activities in these countries.
What are the entity's major assets?	The major assets of the company are inventory; property, plant and equipment; and its customer mailing list.	No.
What are the entity's major liabilities?	The company has no long-term debt. However, it maintains a line of credit for financing purchases during the peak purchasing season.	No. The company has cash flow to meet its current obligations.
What are the entity's financial characteristics including financing sources and current and prospective financial condition?	The company uses its line of credit to meet its normal financing activities. Overall the company's financial condition is good.	No.
Are there any potential related parties?	No.	No.
Are there any individually significant events and transactions such as acquisitions or disposals of subsidiaries, businesses, or product lines during the year?	The expansion of the company's Internet presence to ten more countries.	Yes. Restrictive trade laws.
Does the entity have any major uncertainties or contingencies?	No.	No.



LO10

## COMMUNICATIONS ABOUT FRAUD TO MANAGEMENT, THOSE CHARGED WITH GOVERNANCE AND OTHERS

Whenever the auditor has found evidence that a fraud may exist, that matter should be brought to the attention of an appropriate level of management. Fraud involving senior management and fraud that causes a material misstatement of the financial statements should be reported direct to those charged with governance, for example the board of directors or the audit committee, if any. In addition, the auditor should reach an understanding with those charged with governance regarding the expected nature and extent of communications about misappropriations perpetrated by lower-level employees.

The disclosure of fraud to parties other than the client's senior management and those charged with governance ordinarily is not part of the auditor's responsibility and ordinarily would be precluded by the auditor's ethical or legal obligations of confidentiality. The auditor's legal responsibilities vary by country, and in certain circumstances the duty of confidentiality may be overridden by statute, the law or courts of law. For example, in some countries, the auditor of a financial institution has a statutory duty to report the occurrence of fraud to supervisory authorities. Also, in some countries the auditor has a duty to report misstatements to authorities in those cases where management and those charged with governance fail to take corrective action. The IFAC Code of Ethics for Professional Accountants provides guidance on circumstances where auditors should disclose confidential information or when such disclosure may be appropriate (see Chapter 19 for a discussion of the IFAC Code of Ethics and the auditor's obligations of confidentiality).



LO11

## MATERIALITY<sup>v</sup>

The auditor's consideration of materiality on an audit is a matter of *professional judgement*. It reflects the auditor's perception of how misstatements could reasonably be expected to influence the economic decisions of users of the financial statements. The applicable financial reporting framework often discusses materiality.<sup>vi</sup> Such discussion in the context of the preparation and presentation of financial statement provides a frame of reference to the auditor in determining a materiality. Although financial reporting frameworks may discuss materiality in different terms, they generally explain the materiality concept as follows:

*Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. Judgements about materiality are made in light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both. (ISA 320)*

Auditing standards refer to users as a group, not specific individual users, and provide guidance to auditors' professional judgements in assessing the common financial information needs of such users of financial statements. It is reasonable for the auditor to assume that users:

- 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.
- Understand that financial statements are prepared and audited to levels of materiality.
- Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgement, and the consideration of future events.
- Make reasonable economic decisions on the basis of the information in the financial statements (ISA 320, para. 4).

The concept of materiality is applied by the auditor (1) in *planning* and *performing* the audit; and (2) in *evaluating* the effect of **identified misstatements** on the audit and in *evaluating* the effect of **uncorrected misstatements** on the financial statements and in forming the opinion in the auditor's report.

The following sections present an approach to assessing materiality, which is then followed by an example. The presentation is based on the general approach provided by auditing standards (ISA 320 and ISA 450). While the policies and procedures of individual audit firms may differ in some respects, the approach presented here provides the reader with a basic framework for understanding the consideration of materiality in an audit.

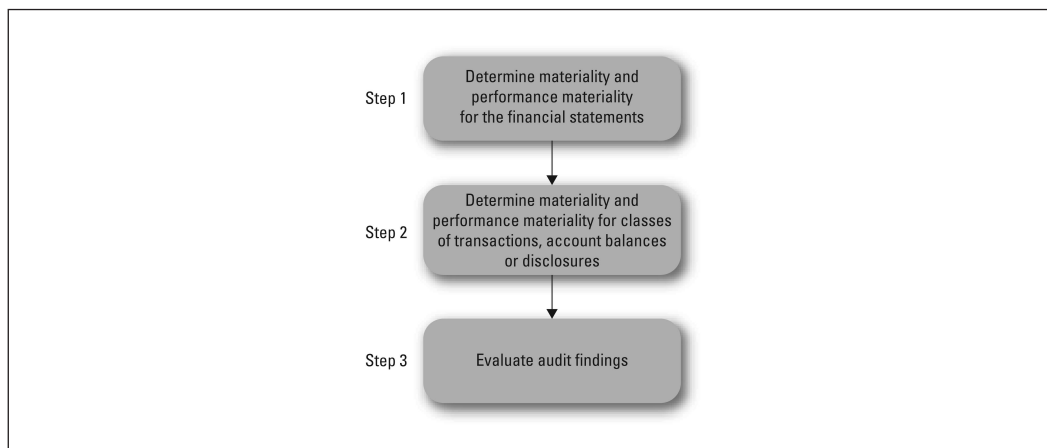




## Steps in Applying Materiality

LO12

Figure 3–4 presents the three major steps in the application of materiality to an audit. Steps 1 and 2 are normally performed early in the engagement as part of planning the audit. Step 3 is performed usually prior to, or when the auditor evaluates the evidence at the completion of the audit to determine if it supports the fair presentation of the financial statements.



**Figure 3–4 Steps in Applying Materiality on an Audit**

### *Step 1: Determine Materiality and Performance Materiality for the Financial Statements*

In Step 1 the auditor first establishes the materiality level for the financial statements as a whole, and then determines a lower amount, **performance materiality**, to establish the scope for the audit procedures.

Materiality is the maximum amount by which the auditor believes the financial statements could be misstated and still *not* reasonably be expected to affect the decisions of users taken on the basis of the financial statements. Materiality, however, is a relative, not an absolute, concept. For example, €5,000 might be considered highly material for a small sole proprietorship, but this amount would clearly be immaterial for a large multinational company. Thus, the relative size of the company being audited affects materiality.

A *percentage* is often applied to a chosen *benchmark* as a starting point in determining materiality. Factors that may affect the identification of an appropriate benchmark include the following:

- The elements of the financial statements such as assets, liabilities, equity, revenue and expenses.
- Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused.
- The nature of the entity, where the entity is in its life cycle, and the industry and economic environment in which the entity operates.
- The entity's ownership structure and the way it is financed.
- The relative volatility of the benchmark (ISA 320, para. A3).

Examples of benchmarks that might be appropriate include categories of reported income such as total revenues, total expenses, gross profit and profit before tax. Profit before tax from continuing operations is often used for profit-oriented entity. Net asset value or total equity might be suitable as a benchmark for asset-based entities (e.g. investment funds). For small owner-managed entities a benchmark such as profit before the owner's remuneration and tax might be suitable. Lastly, for a not-for-profit entity, total revenues or total expenses might be appropriate benchmarks.

Determining a percentage to be applied to a chosen benchmark also involves the exercise of professional judgement. A common rule of thumb is to use 5 per cent of profit before tax for profit-oriented entities. However, if current-year profit before tax is not stable, the entity is close to breaking even or experiencing a loss, auditors might use an average of the previous years' profit or another base. For example, suppose that an entity has profit before taxes of €3,000,000 one year and the auditor decides that 5 per cent of that amount, €150,000, would be material. Suppose, in the following year, the entity's profit before taxes falls to €250,000 due to a temporary decrease in sales prices for its products. If the

auditor uses the 5 per cent factor, the materiality would be €12,500 ( $€250,000 \times 0.05$ ), and a much more extensive audit would be required. Thus, using an average of the prior three years' profit or another base such as total assets or total revenues may provide a more stable benchmark from year to year. The percentage applied to total assets or total revenues will ordinarily be lower than the percentage applied to profit before tax.

At the planning stage the auditor should also determine *performance materiality*. Performance materiality is determined for the purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures. Performance materiality is set at a *lower* amount than materiality to provide a *margin* for possible undetected misstatements. This reduces the risk that the aggregate of uncorrected and undetected misstatements will exceed materiality for the financial statements. Undetected misstatements could exist because of the presence of sampling risk and non-sampling risk. Performance materiality judgements may be affected by factors such as the auditor's understanding of the entity, and the nature and extent of misstatements identified in previous audits and thereby the auditor's expectations in relation to misstatements in the current period.

The auditor's documentations should include the amount and factors considered in determination of materiality, performance materiality and, if determined, the materiality level or levels for particular classes of transactions, account balances or disclosures (Step 2).

### ***Step 2: Determine Materiality and Performance Materiality for Classes of Transactions, Account Balances or Disclosures***

In Step 2 the auditor establishes, if appropriate, materiality levels for particular classes of transactions, account balances or disclosure. Auditing standards require that the auditor *in the specific circumstances of the entity* determines lesser amounts than materiality for the financial statements as a whole for particular classes of transactions, account balances or disclosures. The auditor concludes on this matter based on his or her expectations on how misstatements in classes of transactions, account balances or disclosures reasonably could influence the economic decisions of users taken on the basis of the financial statements. Factors indicating the need to determine lesser materiality levels for particular classes of transactions, account balances or disclosures include:

- Whether law, regulation or the applicable financial reporting framework affect users' expectations regarding the measurement or disclosure of certain items, for example related party transactions and the remuneration of management and those charged with governance.
- The key disclosures in relation to the industry in which the entity operates, for example research and development costs for a pharmaceutical company.
- Whether attention is focused on a particular aspect of the entity's business that is separately disclosed in the financial statements, for example a newly acquired business.

To summarize, the auditor *may or may not* conclude that it is appropriate to determine materiality levels to be applied to particular classes of transactions, account balances or disclosures. If, however, the auditor concludes that such determination is appropriate based on the financial information needs of the users of the financial statements, the auditor will when evaluating audit findings compare whether the determined materiality levels for the particular classes of transactions, account balances or disclosures have been exceeded (Step 3).

For the purpose of establishing the scope of audit procedures the auditor may also find it appropriate to determine performance materiality for classes of transactions, account balances or disclosures. Again, the lower performance materiality provides a margin for undetected misstatements, thereby reducing the risk that the aggregate of undetected and uncorrected misstatements could be material.

### **Practice Insight 3.5**

The specific policies and procedures of the individual audit firm on materiality may differ in some respects, for example in allocating materiality to individual elements of financial statements. Some firms do not practise such allocation, while other firms may systematically allocate materiality to accounts and classes of transactions for planning purposes. For example, a computational benchmark may be to allocate 50 to 75 per cent of materiality for the financial statements to an account, depending on relevant qualitative factors in the circumstances. Obviously, this approach results in an allocation of combined allocated materiality that is greater than materiality for the financial statements. There are a number of reasons why such allocation makes sense from an audit planning perspective. For instance,

not all accounts will be misstated by the full amount of their allocation, and when misstatements are identified in an account, the auditors typically perform additional procedures in that, and related, accounts.

As the *audit progresses* the auditor should revise materiality when becoming aware of new information that would have caused the auditor to have determined a different amount initially. For example, if during the audit it appears as though actual financial results are likely to be substantially different from the anticipated period-end financial results that were used initially to determine materiality, the auditor revises that materiality. When this occurs, the auditor should document the reasons for using a different materiality level.

### Step 3: Evaluate Audit Findings

Step 3 is completed near the end of the audit, when the auditor evaluates all the evidence that has been gathered. Based on the results of the audit procedures conducted, the auditor aggregates identified misstatements, other than those that are judged clearly trivial. Matters are clearly trivial when the auditor expects that the accumulation of such amounts would not have a material effect on the financial statements.

As discussed in a prior section in this chapter, identified misstatements may be classified as factual misstatements, judgemental misstatements (the *Advanced Module* section at the end of this chapter discusses judgemental misstatements related to accounting estimates) and projected misstatements (discussed in Chapter 9). In evaluating the effect of the *identified* misstatements on the *audit*, the auditor compares the aggregate identified misstatement with materiality, including appropriate materiality levels for classes of transactions, account balances and disclosures. If the identified misstatement approaches materiality, there may be greater than an acceptable low level of risk that the identified misstatement and possible undetected misstatements in aggregate could exceed materiality. In such cases the auditor should determine whether the overall *audit strategy* and *audit plan* are appropriate. Further, the nature of identified misstatements and the circumstances of their occurrence may indicate that other misstatements may exist. For example, other misstatements may exist when auditor identifies a misstatement that arose from a breakdown in internal control or from the entity's application of an inappropriate valuation method. If such misstatements could be material when aggregated with misstatements accumulated during the audit, the auditor should also determine whether the overall audit strategy and audit plan need to be revised.

The auditor *communicates* on a timely basis, ordinarily as a continual and interactive process, identifies misstatements accumulated during the audit with the appropriate level of *management* and requests management to correct those misstatements. If management refuses to correct misstatements communicated, the auditor obtains an understanding of management's reasons for not making the corrections. Such understanding is taken into account when evaluating whether the financial statements are free from material misstatement. The auditor communicates any uncorrected misstatements and the effect that they may have on the audit opinion to *those charged with governance*, and requests uncorrected misstatements to be corrected. Finally, the auditor requests a *written representation* from management and, where appropriate, those charged with governance whether they believe the effects of any remaining uncorrected misstatements are immaterial. Pause for a moment, and consider how these requirements and procedures may encourage the entity to correct identified misstatements.

In evaluating the effect of *uncorrected* misstatements on the financial statements, the auditor determines whether the uncorrected misstatements are material, either individually or when aggregated with other misstatements. When appropriate, the auditor also determines if the uncorrected misstatements for particular classes of transactions, account balances and disclosures are material (cf. Step 2). In the process the auditor considers the size and nature of the misstatements as well as the particular circumstances of their occurrence. For example, a client may have illegally paid a commissioned agent to secure a sales contract. While the amount of the illegal payment may be immaterial to the financial statements, the disclosure of the illegal act may result in loss of the contract and substantial penalties that may be material. Table 3–8 presents a list of examples of circumstances that may be considered in evaluating materiality of uncorrected misstatements. Such circumstances may cause the auditor to evaluate misstatement as material, individually or when considered together with other misstatement accumulated during the audit, even if they are lower than materiality levels set at Steps 1 and 2.

**Table 3–8 Examples of Circumstances that May Affect Evaluating Materiality of Uncorrected Misstatements**

- Whether the misstatement involves fraud or illegal acts, for example the concealment of an unlawful transaction.
- Whether the misstatement has the effect of increasing management's compensation, for example by ensuring that the requirements for the award of bonuses are satisfied.
- Whether the misstatement relates to items involving particular parties such as related parties.
- Whether the misstatement affects compliance with regulatory requirements, for example information required by supervisory authorities.
- Whether the misstatement affects compliance with contractual requirements, for example with loan covenants.
- Whether the misstatement affects ratios, financial statements items or disclosure used to evaluate the entity, for example segment information.
- Whether the misstatement masks a change in earnings or other trends.
- Whether the misstatement is a misclassification between balance sheet line items or affects the income statement.
- Whether the misstatement relates to the incorrect selection or application of an accounting policy that has an immaterial effect on the current period's financial statements but is likely to have a material effect on future periods' financial statements.
- Whether the misstatement affects other information that will be communicated in documents containing the audited financial statements, for example in the annual report.

The auditor also considers the effect of uncorrected misstatements related to prior periods on the current period. (Discussion Case 3–23 covers the auditor's consideration of prior periods' uncorrected misstatements in the evaluation of current-year audit results.)

When uncorrected misstatements are evaluated material, the auditor should issue a qualified or adverse opinion because the financial statements do not present fairly in all material respects. When the uncorrected misstatements are evaluated immaterial and the relevant qualitative aspects of the entity's accounting practices and financial statements do not imply otherwise (refer to Chapter 18 for a discussion of relevant qualitative aspects), the auditor can conclude that the financial statements as a whole are free from material misstatement.

The auditor should *document* the amount below which misstatements would be regarded as clearly trivial; all identified misstatements during the audit and whether they have been corrected; and the auditor's conclusion as to whether uncorrected misstatements are material and the basis for that conclusion.

### Practice Insight 3.6

If an individual misstatement is judged to be material, auditing standards consider it is unlikely that it can be offset by other misstatements (ISA 450). For example, if revenue has been materially overstated, the financial statements as a whole will be materially misstated, even if the effect of the misstatement on earnings is completely offset by an equivalent overstatement of expenses. It may be appropriate to offset misstatements within the same account balance or class of transactions; however, the risk that further undetected misstatements may exist is considered before concluding that offsetting even immaterial misstatements is appropriate.

Determining whether a classification misstatement is material involves the evaluation of qualitative considerations. There may be circumstances where the auditor concludes that a classification misstatement is not material in the context of the financial statements as a whole, even though it may exceed the materiality level or levels applied in evaluating other misstatements.



### An Example

**LO13** In this example, the three steps for applying materiality are illustrated, using financial information for EarthWear Clothiers for the year ended 31 December 2009. This financial information is taken from the case illustration included in Chapter 1.

#### *Step 1: Determine Materiality and Performance Materiality for the Financial Statements*

EarthWear Clothiers' net profit before taxes is €36 million (rounded). Assume that the auditors, Willis & Adams, have decided that 5 per cent of this benchmark is appropriate for materiality for the financial

statements as a whole. Thus, they determine materiality for the financial statements as a whole to be €1,800,000 ( $€36,000,000 \times .05$ ). For the purpose of establishing the scope of audit procedures the auditors set performance materiality at €1,700,000.

**Step 2: Determine Materiality and Performance Materiality for Classes of Transactions, Account Balances or Disclosures**

In our example, for simplicity of presentation, we assume that EarthWear’s auditors determine that €900,000 is the materiality level for each account and class of transactions, i.e. €900,000 is relevant amount for evaluating the materiality of audit findings in accounts and class of transactions.

**Step 3: Evaluate Audit Findings**

Auditing standards require that the auditor document all identified misstatements accumulated during the audit. Exhibit 3–4 presents an example of a working paper that can be used to aggregate the effects of misstatements identified during the audit. Assume that during the course of the audit the auditor identified four misstatements. In the example, misstatements are compared to the materiality for the financial statements as well as the materiality levels set for each account and class of transactions. For example, the first misstatement indicates a factual misstatement in the accrual of payroll expense and bonuses. The total misstatement of accrued payroll is €215,000. The second entry is based on the results of a statistical sampling application for inventory. The statistical results indicated a projected misstatement of €312,500. In this example no identified misstatements in individual accounts or class of transactions are larger than their materiality of €900,000, and the total identified misstatements are less than materiality for the financial statement as a whole. Before concluding on the effect of the identified misstatements on the *audit*, the auditors consider if the nature and circumstances related to identified misstatements indicate further possible misstatements. For example, the auditors consider further possible misstatements that may be due to sampling.

<b>Exhibit 3–4 Example Working Paper for Proposed Adjusting Entries</b>						
<b>EARTHWEAR CLOTHIERS</b>						
<b>Schedule of Proposed Adjusting Entries 31/12/09</b>						
<i>Working Paper Ref.</i>	<i>Proposed Adjusting Entry</i>	<i>Assets</i>	<i>Liabilities</i>	<i>Equity</i>	<i>Revenues</i>	<i>Expenses</i>
N10	Payroll expense					75,000
	Bonuses					140,000
	Provisions		215,000			
	To accrue payroll through 31/12 and recognize 2009 bonuses					
F20	Cost of sales					312,500
	Inventory	(312,500)				
	To adjust ending inventory based on sample results					
F22	Inventory	227,450				
	Accounts payable		227,450			
	To record inventory in transit at 31/12					
R15	Accounts receivable	79,850				
	Sales				79,850	
	To record sales cut-off errors at 31/12					
	<b>Total</b>	<b>€(5,200)</b>	<b>€442,450</b>		<b>€79,850</b>	<b>€527,500</b>

Materiality for classes of transactions and account balances = €900,000.  
**Conclusion:** Based on the above analysis, the account balances for EarthWear Clothiers are fairly stated in accordance with the applicable financial reporting framework.

Although not considered material, Willis & Adams will request management to correct the identified misstatements. If the aggregate of the uncorrected misstatements were in excess of materiality for the financial statement as a whole or the uncorrected misstatements in an account or class of transactions were in excess of their set materiality, the auditor would have to issue a qualified or adverse opinion.



LO14

## ADVANCED MODULE: AUDITING OF ACCOUNTING ESTIMATES, INCLUDING FAIR VALUE ACCOUNTING ESTIMATES

ISA 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* deals with the overarching process on how the auditor obtains sufficient appropriate audit evidence as to whether accounting estimates are *reasonable* and related disclosures are *adequate*. ISA 540 tailors the requirements in other ISAs to the auditing of accounting estimates. Particularly, the standard expands on how accounting estimates are integrated in the auditor's assessment and response to risks of material misstatements and evaluation of audit findings.

This chapter discusses auditing of accounting estimates in relevant sections. When relevant, the business process chapters (Chapters 10–16) as well as other chapters include discussions of auditing of accounting estimates. This *Advanced Module* offers a discussion of auditing of accounting estimates in more detail.

*Accounting estimates* are financial statements items that cannot be measured precisely, but can only be estimated. The estimation may relate to forecasting the outcome of a transaction, event or condition, giving rise to the need for the accounting estimate, such as when estimating the allowance for uncollectable accounts. The estimation of the allowance for uncollectable accounts is affected by such factors as the client's credit-granting and cash-collection policies, and the financial strength of the client's customers. In fair value accounting, estimates are expressed in terms of the value of a current transaction or financial statement item based on conditions prevalent at the measurement date. The *fair value accounting estimate* of a financial statement item may be the prevalent estimated market price of a particular type of asset or liability. The value of a current transaction is the prevalent estimated price at which the transaction would occur rather than settlement at some past or future date. Such an estimate may sometimes be an assumed hypothetical current transaction between knowledgeable, willing parties in an arm's length transaction. For example, the estimate may relate to the fair values at the acquisition date and subsequent periods of goodwill and intangible assets acquired in a business combination.

Auditing standards define accounting estimates as follows:

**Accounting estimates** is an approximation of a monetary amount in the absence of a precise means of measurement. This term is used for an amount measured at fair value where there is estimation uncertainty, as well as for other amounts that require estimation.

Examples of situations where accounting estimates, other than fair value accounting estimates, may be required include:

- Allowance for uncollectable accounts including loan loss reserves.
- Inventory obsolescence.
- Warranty obligations.
- Depreciation method and asset useful life.
- Provisions.
- Pensions.
- Construction contracts and other long-term contracts.
- Litigation outcomes.

Examples of situations where fair value accounting estimates may be required include:

- Financial instruments.
- Share-based payments.
- Property, plant and equipment.
- Goodwill and intangible assets acquired in a business combination.
- Non-monetary exchanges.

Fair value accounting estimates may also be required to evaluate and determine possible impairment of an asset or liability.

The nature and reliability of information available to management to support the making of an accounting estimate vary widely. This affects the degree of **estimation uncertainty** associated with accounting estimates and therefore the risk of material misstatement of accounting estimates. Some accounting estimates, however, involve relatively low estimation uncertainty and may give rise to lower risks of material misstatements. This includes accounting estimates that are frequently made and updated because they relate to routine transactions, estimates derived from data that are readily available, such as published interest rate data, and fair value accounting estimates where there is an active market that provides readily available and reliable information on the prices at which actual exchanges occur. In



contrast, other accounting estimates may have relatively high estimation uncertainty, particularly when they are based on significant and uncertain assumptions such as the outcome of litigation, and fair value measurements in inactive markets, or where models for calculating fair values and their assumptions are not reliable or readily available.

### Identifying and Assessing the Risks of Material Misstatements for Accounting Estimates

In obtaining an understanding of the entity and its environment in order to provide a basis for identification and assessment of risks of material misstatement of accounting estimates, the auditor obtains an understanding of:

- The requirements of the applicable financial framework relevant to accounting estimates, including related disclosures.
- How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognized or disclosed in the financial statements.
- How management makes the accounting estimates and an understanding of the data on which they are based, including methods and, where applicable, the model used, as well as change or need for change in methods used; relevant controls; the assumptions underlying the accounting estimate; whether management has used an expert; and whether and, if so, how management has assessed the effect of estimation uncertainty.

A review of the outcome of prior-period accounting estimates is also part of the auditor's understanding for identification and assessment of accounting estimates in the current period.

In identifying and assessing the risks of material misstatement the auditor evaluates the degree of *estimation uncertainty* associated with an accounting estimate. The degree of estimation uncertainty may be influenced by factors such:

- The extent to which the accounting estimate depends on judgement.
- The sensitivity of the accounting estimate to changes in assumptions.
- The existence of recognized measurement techniques that may mitigate the estimation uncertainty.
- The length of the forecast period, and the relevance of data drawn from past events to forecast future events.
- The availability of reliable data from external sources.
- The extent to which the accounting estimate is based on observable or unobservable inputs.

If an accounting estimate has high estimation uncertainty, it gives rise to a significant risk. Auditing standards guide extensively on how the auditor identifies and assesses the risk of material misstatements of accounting estimates, including assessment of accounting estimate uncertainty and what is constituting a high estimation uncertainty (ISA 540, paras A12–A51).

### Responses to the Assessed Risks of Material Misstatements for Accounting Estimates

Based on the assessed risks of material misstatement of the accounting estimates the auditor *determines* (1) whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate, and (2) whether the methods for making the accounting estimates are appropriate and have been applied consistently, as well as the appropriateness of any changes in method.

In responding to assessed risks of material misstatement of accounting estimates, the auditor takes into account the nature of the accounting estimate. For example, for the allowance for doubtful accounts, an effective procedure for the auditor may be to review subsequent cash collections in combination with other procedures. Other appropriate responses than to base audit evidence on events occurring up to the date of the auditor's report include testing how management made the accounting estimate and the data on which it is based, testing the operating effectiveness of the controls over how management made the accounting estimate, and developing a point estimate or a range to evaluate management's point accounting estimate. An accounting estimate that gives rise to a significant risk requires further substantive procedures related to how management has addressed the estimation uncertainty, management's decision to recognize or not recognize the accounting estimate in the financial statements, and the selected



measurement basis for the accounting estimate. Auditing standards provide extensive guidance for the auditor's response to assessed risk of material misstatement of accounting estimates, including responses to significant risks (ISA 540, paras A52–A115).

## Evaluating the Reasonableness of Accounting Estimates, and Concluding

Based on the audit evidence the auditor evaluates whether the accounting estimate is reasonable or is misstated, and whether the disclosure is adequate. For instance, the auditor may have concluded that it is appropriate to use a range for evaluation of management's point estimate. In this situation the auditor has narrowed the range, based on audit evidence available, until all outcomes within the range are considered reasonable. Ordinarily, a range that has been narrowed to be equal to or less than performance materiality is adequate. In evaluating the reasonableness of management's point estimate the auditor determines whether the range supports the recorded estimate by management. To illustrate, where audit evidence supports the auditor's use of a point estimate, the difference between the auditor's point estimate and management's point estimate constitutes a judgemental misstatement. Where the auditor has concluded that using a *range* is appropriate, a management point estimate that lies outside the auditor's range is not supported by audit evidence. In such cases, the misstatement is no less than the difference between management's point estimate and the nearest point of the auditor's range. For example, suppose that the auditor concludes, based on the evidence, that the allowance for doubtful accounts should be between €210,000 and €270,000. If management's recorded estimate falls within this range (say €250,000), the auditor may conclude that the recorded amount is reasonable and no difference would be aggregated. If the recorded estimate falls outside this range (say €190,000), the difference between the recorded amount and the amount at the nearest point of the auditor's range (€20,000) would at minimum be aggregated as a judgemental misstatement.

Although auditing standards assist the auditor to form an appropriate conclusion about the reasonableness of accounting estimates and adequacy of related disclosures, the *reliability* of audit evidence may be a fundamental challenge in the auditing of accounting estimates. This become evident in fair value estimates when market information is either not available or sufficient information is difficult to obtain, such as when markets are not active. Inactive markets lead to the use of valuation models for estimation purposes rather than valuation by market prices. Market changes such as increased uncertainty may cause inactive and illiquid markets. Changes in markets may, however, also require changes in valuation approaches, including of the model choice and model assumptions. Consequently, in such situations the auditor should consider the degree of consistency in and relevance of valuation approach and assumptions. It may be necessary for the auditor to look at a broader set of sources of evidence to accumulate sufficient appropriate evidence. For example, the auditor may decide to use the work of an auditor's expert. It may also become an issue whether the measurement of the accounting estimate is sufficiently reliable to meet the recognition criteria of the applicable financial reporting framework.

During the audit the auditor reviews the judgements and decisions made by management, including the making of accounting estimates, to identify whether there are *indicators of possible management bias*. For example, an indicator of possible **management bias** would be management's selection of significant assumptions underlying accounting estimates that yield a point estimate favourable for management objectives. Indicators of possible management bias may affect the auditor's conclusion as to whether the auditor's risk assessment and related responses remain appropriate. The auditor may also need to consider the implications of the presence of such indicators for the rest of the audit and the audit opinion.

Before ending this module, pause for a moment and reflect on the following challenges for preparers and auditors in considering fair value accounting estimates, particularly in times and markets with high uncertainty:<sup>vii</sup>

- The measurement objective, as fair value accounting estimates are expressed in terms of the value of a current transaction or financial statement item based on conditions prevalent at the measurement date.
- The need to incorporate judgements concerning significant assumptions that may be made by others such as experts employed or engaged by the entity or the auditor.
- The availability (or lack thereof) of information or evidence and its reliability.
- The breadth of assets and liabilities to which fair value accounting may be, or is required to be, applied.
- The choice and sophistication of acceptable valuation techniques and models.

- The need for appropriate disclosure in the financial statements about measurement methods and uncertainty, especially when relevant markets are illiquid.



## Key Terms

**Accounting estimate.** An approximation of a monetary amount in the absence of a precise means of measurement. This term is used for an amount measured at fair value where there is estimation uncertainty, as well as for other amounts that require estimation.

**Accounting policies (IAS 8).** The specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.

**Analytical procedures.** Evaluations of financial information through analysis of plausible relationships among both financial and non-financial data.

**Audit procedures.** Specific acts performed as the auditor gathers evidence to determine if specific audit assertions are being met.

**Audit risk.** The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk.

**Auditor's business risk.** The risk that the auditor is exposed to loss or injury to professional practice from litigation, adverse publicity, or other events arising in connection with financial statements audited and reported on.

**Business risks (clients).** Risks resulting from significant conditions, events, circumstances, actions or inactions that may adversely affect the entity's ability to execute its strategies and to achieve its objectives.

**Control risk.** The risk that material misstatements that could occur will not be prevented, or detected and corrected by internal controls.

**Detection risk.** The risk that the auditor will not detect a material misstatement that exists in the financial statements.

**Error.** An unintentional misstatement or omission of an amount or a disclosure.

**Estimation uncertainty.** The susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.

**Factual misstatements.** Misstatements about which there is no doubt.

**Fair value.** The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

**Fraud.** Intentional misstatement that can be classified as fraudulent financial reporting and/or misappropriation of assets.

**Fraud risk factors.** Events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

**Identified misstatements.** The aggregate of factual misstatements, judgemental misstatements and projected misstatements.

**Inherent risk.** The susceptibility of an assertion to material misstatement, assuming no related controls.

**Judgemental misstatements.** Differences arising from the judgements of management concerning accounting estimates that the auditor considers unreasonable, or the selection or application of accounting policies that the auditor considers inappropriate.

**Management bias.** A lack of neutrality by management in the preparation and presentation of information.

**Materiality.** Misstatements, including omissions, that individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. Judgements about materiality are made in light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both.

**Misstatements.** A difference between the amount, classification, presentation or disclosure of a reported financial statement item and the amount, classification, presentation or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

**Performance materiality.** The amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that

the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.

**Professional judgement.** The application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement.

**Professional scepticism.** An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

**Projected misstatements.** Best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn.

**Risk assessment.** The identification, analysis, and management of risks relevant to the preparation of financial statements that are fairly presented in accordance with the applicable financial reporting framework.

**Risk assessment procedures.** The audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control.

**Scope of the audit.** Refers to the nature, timing and extent of audit procedures, where nature refers to the type of evidence; timing refers to when the evidence will be gathered; and extent refers to how much of the type of evidence will be evaluated.

**Significant risk.** An identified and assessed risk of material misstatement that in the auditor's judgement requires special audit consideration.

**Uncorrected misstatements.** Misstatements that the auditor has accumulated during the audit and that have not been corrected.



## Review Questions

- |            |      |  |
|------------|------|--|
| LO1        | 3–1  | Distinguish between audit risk and auditor's business risk.  |
| LO1,2      | 3–2  | How do inherent risk and control risk differ from detection risk?  |
| LO4        | 3–3  | What are some limitations of the audit risk model?   |
| LO2        | 3–4  | Distinguish between sampling and non-sampling risk.  |
| LO5,6      | 3–5  | In understanding the entity and its environment, the auditor gathers knowledge about which categories of information?  |
| LO5,6      | 3–6  | Give three examples of conditions and events that may indicate the existence of (client) business risks.   |
| LO5,6      | 3–7  | Distinguish between error and fraud. Give three examples of each.  |
| LO11,12    | 3–8  | Why is it important for audit firms to develop policies and procedures for establishing materiality?   |
| LO12       | 3–9  | List and describe the three major steps in applying materiality to an audit.   |
| LO12       | 3–10 | While net profit before taxes is frequently used for calculating materiality, discuss circumstances when total assets or revenues might be better bases for calculating materiality. |
| LO11,12    | 3–11 | Why do auditors determine and apply performance materiality?   |
| LO11,12,13 | 3–12 | List four circumstances that may affect the auditor's evaluation of materiality of uncorrected misstatements.  |



## Problems

**LO1,2,3,11,12 3–13** The auditor should consider audit risk and materiality when planning an audit.

**Required:**

- a** Define audit risk and materiality.
- b** Describe the components of audit risk (e.g. inherent risk, control risk and detection risk).
- c** Explain how these components are interrelated.
- d** Discuss how the auditor determines materiality for the financial statements. (AICPA, adapted)

**LO1,2,3 3–14** The audit firm of Lumley & Lu uses a quantitative approach to implementing the audit risk model. Calculate detection risk for each of the following hypothetical clients.

Client No.	Audit Risk	Risk of Material Misstatement	Detection Risk
1	5%	20%	
2	5%	50%	
3	10%	15%	
4	10%	40%	

**LO1,2,3 3–15** The audit firm of Quigley & Associates uses a qualitative approach to implementing the audit risk model. Audit risk is categorized using two terms: very low and low. The risk of material misstatement and detection risk are categorized using three terms: low; moderate; and high. Calculate detection risk for each of the following hypothetical clients.

Client No.	Audit Risk	Risk of Material Misstatement	Detection Risk
1	Low	Moderate	
2	Very low	High	
3	Low	Low	
4	Very low	Moderate	

**LO1,2,3 3–16** Assume that you are the new audit senior on the LV Drug Corporation (LVD) engagement. LVD is a pharmaceutical company that has three successful drugs and a number of drugs in progress in its research and development pipeline. You are considering detection risk at the financial statement level and it is important to identify the inherent risks and control risks that LVD has and how they relate to audit risk.

**Required:**

For each of the following factors, indicate whether it is an inherent risk or a control risk factor, and its effect on detection risk. In answering this question, assume that each factor is independent of the others.

- a** LVD is a publicly traded company.
- b** Dr Jones is the major shareholder of LVD and its CEO.
- c** Dr Jones has unusual influence over the board of directors.
- d** Your firm has audited LVD for the last four years.
- e** There has been high turnover of key accounting personnel during the last two years.
- f** The internal audit function reports to the audit committee.
- g** LVD signed an exclusive distribution contract with another pharmaceutical company to distribute its latest blockbuster drug – Xarmdon.
- h** During the current year, LVD began leasing a manufacturing facility that is owned by Forge Limited Partners. Dr Jones is a partner in Forge.

- i LVD has been the subject of lawsuits by users of Framadon, who claim that the drug affects their liver function. LVD is confident that there are no side effects from the use of Framadon.
- j The Medical Control Agency has begun an investigation into LVD's compliance procedures over its drug testing on human subjects.

LO1,2,3

3–17

When planning a financial statement audit, an auditor must understand audit risk and its components. The firm of Pack & Peck evaluates the risk of material misstatement (RMM) by disaggregating RMM into its two components: inherent risk and control risk.

**Required:**

For each illustration, select the component of audit risk that is most directly illustrated. The components of audit risk may be used once, more than once or not at all.

**Components of Audit Risk:**

- a Control risk.
- b Detection risk.
- c Inherent risk.

Illustration	Component of Audit Risk
1. A client fails to discover employee fraud on a timely basis because bank accounts are not reconciled monthly.	
2. Cash is more susceptible to theft than an inventory of coal.	
3. Confirmation of receivables by an auditor fails to detect a material misstatement.	
4. Disbursements have occurred without proper approval.	
5. There is inadequate segregation of duties.	
6. A necessary substantive audit procedure is omitted.	
7. Notes receivable are susceptible to material misstatement, assuming there are no related internal controls.	
8. Technological developments make a major product obsolete.	
9. XYZ Company, a client, lacks sufficient working capital to continue operations.	

LO3,5,6

3–18

For each of the following situations, explain how risk of material misstatement should be assessed and what effect that assessment will have on detection risk.

- a Johnson is a fast-growing trucking company. The company is publicly held, but Ivan Johnson and his sons control 55 per cent of the stock. Ivan Johnson is chairman of the board and CEO. He personally makes all major decisions with little consultation with the board of directors. Most of the directors, however, are either members of the Johnson family or long-standing friends. The board basically rubber-stamps Ivan Johnson's decisions.
- b MaxiWrite Corporation is one of several companies engaged in the manufacture of high-speed, high-capacity data storage devices. The industry is very competitive and subject to quick changes in technology. MaxiWrite's operating results would place the company in the second quartile in terms

- of profitability and financial position. The company has never been the leader in the industry, with its products typically slightly behind the industry leaders in terms of performance.
- c The Focus Bank has been your client for the past two years. During that period you have had numerous arguments with the president and the controller over a number of accounting issues. The major issue is related to the bank's reserve for loan losses and the value of collateral. Your prior audits have indicated that a significant adjustment is required each year to the loan loss reserves.
- LO5,6,9**      **3–19**      Management fraud (e.g. fraudulent financial reporting) is a relatively rare event. However, when it does occur, the frauds (i.e. Enron and Parmalat) can have a significant effect on shareholders, employees and other parties. ISA 240 provides the relevant guidance for auditors.
- Required:**
- a What is the auditor's responsibility for detecting fraud?
  - b Describe the three conditions that are generally present when fraud occurs.
  - c What are the objectives of the 'brainstorming' meeting that is held among the audit engagement team members?
  - d What is the required documentation for identified risk factors?
- LO5,6**      **3–20**      Assume that your firm is considering accepting NewSkin Pharma as a new audit client. NewSkin is a startup biotech firm that has publicly traded stock. Your audit partner has asked you to perform some preliminary work for the firm's client acceptance process.
- Required:**
- a Prepare a list of business risks that NewSkin is likely to face as a startup biotech firm.
  - b Choose two of these risks and consider how they might affect your decision to accept NewSkin as a client.
- LO12,13**      **3–21**      For each of the following scenarios determine materiality and evaluate audit findings. Justify your decisions.
- Scenario 1:**
- Murphy & Johnson is a manufacturer of small motors for lawnmowers, tractors and snowmobiles. The components of its financial statements are (1) net profit = €21 million, (2) total assets = €550 million, and (3) total revenues = €775 million.
- During the course of the audit, Murphy & Johnson's audit firm detected two misstatements that aggregated to an overstatement of net profit of €1.25 million.
- Scenario 2:**
- Delta Investments provides a group of mutual funds for investors. The elements of its financial statements are (1) net profit = €40 million, (2) total assets = €4.3 billion, and (3) total revenues = €900 million.
- During the course of the audit, Delta's audit firm detected two misstatements that aggregated to an overstatement of net profit of €5.75 million.
- Scenario 3:**
- Swell Computers manufactures desktop and laptop computers. The elements of the financial statements are: (1) net profit = €500,000, (2) total assets = €2.2 billion, and (3) total revenues = €7 billion.
- During the course of the audit, Swell's audit firm detected one misstatement that resulted in an overstatement of net profit by €1.5 million.





## Discussion Cases

LO5,6

3–22

**CarProof.** CarProof is a public company founded in 2000 to manufacture and sell speciality auto products mainly relating to paint protection and rust proofing. By 2007, the CarProof board of directors felt that the company's products had fully matured and that it needed to diversify. CarProof aggressively sought out new products and in March 2008 it acquired the formula and patent of a specialized motor lubricant (Run-Smooth) from SIM. In addition, the company purchased 15 per cent of SIM's outstanding common stock. At the time of the stock purchase, Steve Matthews owned 100 per cent of SIM; he retained ownership of 85 per cent of SIM after CarProof's 15 per cent purchase. In December 2008, the board of directors appointed Mr Matthews to be president of CarProof.

Run-Smooth is unlike conventional motor lubricants. Its innovative molecular structure accounts for what management believes is its superior performance. Although it is more expensive to produce and has a higher selling price than its conventional competitors, management believes that it will reduce maintenance costs and extend the life of equipment in which it is used.

CarProof's main competitor is a very successful multinational conglomerate that has excellent customer recognition of its products and a large distribution network. To create a market niche for Run-Smooth, CarProof's management is targeting commercial businesses that service vehicle fleets and industrial equipment.

CarProof's existing facilities were not adequate to produce Run-Smooth in commercial quantities. In June 2009 CarProof commenced construction of a new plant. After lengthy negotiation it received a €900,000 grant from the government. The terms of the grant require CarProof to maintain certain employment levels over the next three years or the grant must be repaid. The new facilities became operational on 1 December 2009. CarProof financed its recent expansion with a bank loan. Management is considering issuing additional stock later in 2010 to address the company's cash flow problems.

CarProof's auditors resigned in February 2010, after which Steve Matthews contacted your firm. The previous auditors informed Mr Matthews that they disagreed with CarProof's valuation of deferred development costs for Run-Smooth.

It is now 20 April 2010 and you and a partner in your firm have just met with Steve Matthews to discuss the services your firm can provide to CarProof for the year ending 31 March 2010. During your meeting, you collected the following information:

- CarProof has incurred substantial losses during the past three fiscal years.
- There have been significant orders of Run-Smooth received to date.
- CarProof has commenced a lawsuit against its major competitor for patent infringement and industrial espionage. Management has evidence that it believes will result in a successful action, and wishes to record the estimated gain on settlement of €4 million. Although no court date has been set, legal correspondence shows that the competitor intends 'to fight this action to the highest court'.
- Deferred development costs of €2 million represent material, labour and subcontract costs incurred during 2008 and 2009 to evaluate the Run-Smooth product and prepare it for market. CarProof has not taken any amortization to date but thinks that a period of 20 years would be appropriate.
- Royalties of €0.25 per litre of Run-Smooth produced are to be paid annually to SIM.
- The €3.514 million bank loan is secured by a floating charge over all corporate assets. The loan agreement requires CarProof to undergo an annual environmental assessment of its old and new blending facilities.



As you return to the office, the partner tells you that he is interested in having CarProof as an audit client. He wants a memo from you covering in detail the audit and (Client) business risks you see arising from this potential engagement.

**Required:**

*Prepare the memo requested by the audit partner.*

**LO11,12,13 3–23**

**Wyly Waste Management.** ISA 450 *Evaluation of Misstatements Identified during the Audit* requires the auditor to evaluate the effect of uncorrected misstatements related to prior periods on the current period. The auditing standard acknowledges that there are different acceptable approaches to the auditor's evaluation of such uncorrected misstatements on the current period's financial statements. ISA 450 does not mandate the use of one approach over another, but recognizes that using the same evaluation approach provides consistency from period to period (ISA 450, para. A18).

Two different acceptable approaches to the evaluation of prior periods uncorrected misstatements are:

- 1 *Iron curtain method (balance sheet view)* – this approach quantifies the misstatement based on the amount required to correct the misstatement in the balance sheet at the year end irrespective of the misstatement's year of origination.
- 2 *Rollover method (income statement view)* – this approach quantifies the misstatement based on the amount of the error that originates in the current-year income statement. This approach ignores the effects of correcting the portion of the current-year balance sheet misstatements that originated in prior years (i.e. it ignores the 'carryover effects' of prior-year misstatements).

Your firm is auditor of Wyly Waste Management (WWM). Materiality for the audit is €100,000. Shortly after the end of the year, WWM's CFO is meeting with your audit partner to review the preliminary results of the audit. Your partner presents a copy of the draft unadjusted misstatement summary to the CFO, which contains one misstatement.

During the year, WWM did not capitalize individual expenditures of less than €10,000, which is in accordance with its company policy. In the past, WWM's capital expenditures have been relatively constant each period and the expensing of the items has not caused any material errors. In the prior two years, the expensed items totalled €7,500 and €5,000 respectively. However, in the current year, WWM undertook significant development of a new waste disposal plant. As a result, WWM incurred eight capital expenditures of less than €10,000 each that were not capitalized. These purchases totalled €75,000.

**Required:**

- a *Quantify the misstatement using both the iron curtain approach and the rollover approach. Should your partner require WWM to correct the financial statements in the current year for the expensed items before being willing to issue an unmodified audit opinion?*
- b *Suppose the facts were changed and the expensed items for the prior two years totalled €22,500 and €15,000, respectively. Quantify the misstatement using both the iron curtain approach and the rollover approach. Should your partner require WWM to correct the financial statements in the current year for the expensed items before being willing to issue an unmodified audit opinion; and if a correction is required, by what amount?*



**Internet Assignment**

**LO5,6,7**

**3–24**

Auditors are required to obtain and support an understanding of the entity and its environment in order to identify business risks. Much of the information needed to identify the risks can be obtained from the company's annual report. Many

companies publish these documents on their website. Additionally, industry information on these companies can be obtained from websites such as Yahoo! (<http://yahoo.marketguide.com>).

- a In groups (of two or three members) complete the questionnaire (except for the business process section) for a real-world company assigned by your instructor. There may be some questions asked on the questionnaire that you will be unable to answer. If you cannot answer a question, respond 'information not available'.
- b The measurement and performance section asks for information on the entity's key performance indicators (KPIs). Identify what you think the KPIs are for the company assigned, and how the company compares to its industry averages and major competitors. Prepare tables for this data and a memo of your analyses.

Risk Response Table			
Business Risks	Audit Area Affected	Assertion	Response

## Notes

- i See T.B. Bell, M.E. Peecher and I. Solomon, *The 21st Public Company Audit: Conceptual Elements of KPMG's Global Audit Methodology*, KPMG, 2005, for a detailed discussion of the importance of recognizing the potential for non-sampling risk when conducting an audit.
- ii See B.E. Cushing and J.K. Loebbecke (1983), 'Analytical Approaches to Audit Risk: A Survey and Analysis', *Auditing: A Journal of Practice and Theory*, Fall, pp. 23–41; W.R. Kinney, Jr (1983), 'A Note on Compounding Probabilities in Auditing', *Auditing: A Journal of Practice and Theory*, Spring, pp. 13–22; and W.R. Kinney, Jr (1989), 'Achieved Audit Risk and the Audit Outcome Space', *Auditing: A Journal of Practice and Theory*, pp. 67–84, for more detailed discussions of the limitations of the audit risk model.
- iii See recent surveys by KPMG (*KPMG Forensic: Integrity Survey 2005–2006*, KPMG LLP, New York: 2005) and PwC (4th biennial *Global Economic Crime Survey 2007*, PwC, New York: 2007) for information on the incidence of fraud.
- iv See A. Eilifsen and W.F. Messier, Jr (2000), 'Auditor Detection of Misstatements: A Review and Integration of Empirical Research', *A Journal of Accounting Literature* (19), pp 1–43, for a detailed review of research studies that have examined auditor-detected misstatements.
- v See W.F. Messier, Jr, N. Martinov and A. Eilifsen, 'A Review and Integration of Empirical Research on Materiality: Two Decades Later', *Auditing: A Journal of Practice & Theory* (November 2005), pp. 153–87, for a discussion of materiality research.
- vi For example, International Accounting Standards (IAS) 1, *Presentation of Financial Statements* provides the following definition of materiality: '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.'
- vii IAASB (October 2008) *Staff Audit Practice Alert. Challenges in Auditing Fair Value Accounting Estimates in the Current Market Environment*, [http://web.ifac.org/download/Staff\\_Audit\\_Practice\\_Alert.pdf](http://web.ifac.org/download/Staff_Audit_Practice_Alert.pdf).