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STANDING ADVISORY GROUP MEETING

REVIEW OF RISK ASSESSMENT STANDARDS – THE AUDITOR'S CONSIDERATION OF MATERIALITY IN AUDIT PLANNING AND EVALUATION OF LIKELY MISSTATEMENTS

FEBRUARY 9, 2006

Introduction

Risk assessment and the auditor's consideration of materiality are very closely related. In planning an audit, the auditor considers materiality in assessing the risk of material misstatement and determining the audit procedures to be performed. In evaluating the results of the audit, the auditor considers the effect of detected misstatements on the financial statements.[1/] These processes involve professional judgment and evaluation of qualitative and quantitative factors. Therefore, the auditing standards regarding materiality and audit risk recognize the need for judgment and the auditor's responsibility to apply professional skepticism and due professional care in obtaining reasonable assurance that the financial statements are free of material misstatement.

[1/] This briefing paper discusses the auditor's consideration of materiality in planning the audit and evaluating likely misstatements. It does not address accounting considerations of materiality or the auditor's consideration of uncorrected misstatements arising in prior periods.

This paper was developed by the staff of the Office of the Chief Auditor to foster discussion among the members of the Standing Advisory Group. It is not a statement of the Board; nor does it necessarily reflect the views of the Board or staff.

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AU section ("AU sec.")[2/] 312, *Audit Risk and Materiality in Conducting an Audit,* provides the primary direction to auditors for the consideration of materiality in audit planning and in the evaluation of audit findings in financial statement audits.[3/] The Board seeks the advice of the Standing Advisory Group ("SAG") in considering an appropriate level of direction to auditors regarding these issues.

Consideration of Materiality in Planning the Audit

In planning an audit, the auditor makes a preliminary judgment about materiality. Although this judgment need not be quantitative, it generally is helpful to make quantitative judgments to determine audit scope.[4/] AU sec. 312.19 states, "the auditor ordinarily considers materiality for planning purposes in terms of the smallest aggregate level of misstatements that could be considered material to any one of the financial statements." This preliminary judgment about materiality is sometimes referred to as "planning materiality."

[2/] References to AU sections ("AU secs.") throughout this paper are to the PCAOB's interim auditing standards, which consist of generally accepted auditing standards, as described in the AICPA Auditing Standards Board's Statement of Auditing Standards No. 95, as in existence on April 16, 2003, to the extent not superseded or amended by the Board. These standards are available on the PCAOB's Web site at www.pcaobus.org.

[3/] SEC Staff Accounting Bulletin No. 99¸ *Materiality*, provides guidance on the consideration of materiality in preparing financial statements and performing audits. PCAOB Auditing Standard No. 2 provides additional direction on the consideration of materiality in an audit of internal control over financial reporting. Additionally, the International Auditing and Assurance Standards Board has undertaken a project to revise the International Standard on Auditing 320, *Materiality*, and the Auditing Standards Board of the American Institute of Certified Public Accountants also is amending its standard on audit risk and materiality for audits of non-issuers.

[4/] Audit scope refers to matters such as sample sizes and the determination of items to be examined using other selective techniques.

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Many auditors determine planning materiality using financial benchmarks, generally by applying a percentage to a selected base (e.g., a percentage of net income before taxes, total revenue, total assets, or an industry-specific metric). A specific example would be using five percent of net income before taxes to compute planning materiality for a profitable commercial enterprise. The selection of the base or percentage parameter can substantially affect the determination of planning materiality and audit scope. Because of the widespread use of financial benchmarks and the opportunity for substantial variability in determining audit scopes, it may be appropriate to provide direction to auditors on using financial benchmarks to determine planning materiality. Such direction would need to appropriately balance the objectives of allowing for professional judgment and promoting more consistency in materiality determinations for similar companies.

Discussion Question –

1. Should the auditing standards provide direction on the use of financial benchmarks in determining planning materiality? What is your advice on the nature and extent of that direction?

Consideration of Planning Materiality at the Account and Disclosure Level

During audit planning, the auditor relates the preliminary judgments about planning materiality at the financial statement level to the individual accounts and disclosures in the financial statements. This often results in the auditor determining an amount that is less than what the auditor would consider material to the financial statements taken as a whole. The judgment about planning materiality at the account and disclosure level is commonly referred to as "tolerable misstatement."

There are two important aspects regarding consideration of tolerable misstatement for accounts and disclosures. First, in some cases, misstatement of a particular account or disclosure in an amount less than what the auditor would judge to be material for the financial statements as a whole nevertheless might be significant to financial statement users.[5/] For example, some industries have certain financial metrics

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[5/] This also is consistent with the principle in FASB Concept Statement No. 2 and SEC Staff Accounting Bulletin No. 99 that materiality judgments should include consideration of the nature of the item and the circumstances.

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that are key drivers of value. A misstatement affecting those metrics might be significant to users, even if it is less than the judgment about materiality for the financial statements taken as a whole. Second, misstatements that are individually immaterial sometimes aggregate to an amount that is material to the financial statements.

AU sec. 312.25 provides the following direction on how to consider materiality at the account and disclosure level:

> In determining the nature, timing, and extent of auditing procedures to be applied to a specific account balance or class of transactions, the auditor should design procedures to obtain reasonable assurance of detecting misstatements that he or she believes, based on the preliminary judgment about materiality, could be material, when aggregated with misstatements in other balances or classes, to the financial statements taken as a whole. Auditors use various methods to design procedures to detect such misstatements. In some cases, auditors explicitly estimate, for planning purposes, the maximum amount of misstatements in the balance or class that, when combined with misstatements in other balances or classes, could exist without causing the financial statements to be materially misstated. In other cases, auditors relate their preliminary judgment about materiality to a specific account balance or class of transactions without explicitly estimating such misstatements.

There are many ways to relate judgments about materiality for the financial statements taken as a whole to the individual accounts and disclosures. For example, auditors might allocate planning materiality proportionally to the individual accounts. Alternatively, they might apply specified percentages, such as 50 or 75 percent, of planning materiality to determine tolerable misstatement at the individual account and disclosure level.

Discussion Question –

2. Should the auditing standards require auditors to specify tolerable misstatement for significant accounts and disclosures? If not, what alternative would you recommend?

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Adjustments of Audit Scope Overall

AU sec. 312.17 states, "Whenever the auditor has concluded that there is significant risk of material misstatement of the financial statements, the auditor should consider this conclusion in determining the nature, timing, or extent of procedures; assigning staff; or requiring appropriate levels of supervision." For example, in an audit that the auditor considers "high risk," he or she could adjust the audit scope overall (i.e., increase the extent of audit testing overall),[6/] or adjust the scope only for certain accounts or audit procedures. The interim auditing standards provide little direction on when to consider adjusting the audit scope overall.

Discussion Question –

3. Should the auditing standards provide direction about when to consider adjusting the audit scope overall? What is your advice on the nature and extent of that direction?

Sample Sizes in Substantive Audit Sampling

AU sec. 350, *Audit Sampling*, provides direction on applying audit sampling in performing substantive audit procedures.[7/] AU sec. 350 allows auditors to use either a statistical or a nonstatistical sampling approach. Using a statistical sampling approach, the auditor's sample size is calculated based on the parameters associated with the specific sampling method used. Such parameters generally include the size of the sampling population and the auditor's judgment about the degree of assurance needed from the sampling procedure.

[6/] Increasing audit scope overall includes identifying more accounts and disclosures as significant and increasing sample sizes and the number of items tested in other selective tests. Some auditors might increase audit scope overall by lowering tolerable misstatement for all accounts and disclosures.

[7/] Substantive procedures are tests of account balances and transaction classes (e.g., confirmation of accounts receivable).

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Unlike the statistical sampling approach, there is no generally accepted methodology for the nonstatistical sampling approach. Thus, an auditor using nonstatistical sampling may determine sample sizes based on mathematical calculations or on his or her judgment. AU sec. 350 discusses in qualitative terms the factors that should influence the auditor's sample size under both statistical and nonstatistical sampling approaches. Since the standard provides the same direction regarding sample sizes under both methods, it is reasonable to conclude that sample sizes should be comparable under either approach. However, the lack of definitive direction in the standard might lead some auditors to conclude that he or she may subjectively determine a sample size without consideration of the sample size that would be required under a statistical sampling method. Although there are cost-effectiveness advantages to using a nonstatistical sampling method, those advantages should not include dramatic reductions in sample sizes as compared to those required under a statistical sampling method, for example, a nonstatistical sample of 20 items instead of a statistical sample of 200 items.

Discussion Question –

4. In a substantive audit sampling procedure, should a sample size that is determined using a nonstatistical sampling approach be comparable to a well-designed statistical sample size using equivalent parameters?

Evaluation of Likely Misstatements[8/]

During the evaluation phase of an audit, the auditor considers the results of the audit to determine whether (a) the financial statements are fairly stated in accordance with generally accepted accounting principles and (b) sufficient, competent evidence was obtained to support the auditor's opinion. As part of this evaluation the auditor is required to evaluate misstatements to assess whether, individually or in aggregate, they result in material misstatement of the financial statements. AU sec. 312 describes the auditor's responsibilities with respect to the evaluation of audit findings, including

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[8/] According to AU sec. 312, the auditor's consideration of likely misstatements includes consideration of uncorrected misstatements from prior periods. However, as noted previously, discussion of prior misstatements is beyond the scope of this briefing paper.

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uncorrected misstatements. AU sec. 312.34 describes two categories of misstatements:

- Known misstatement – the amount of misstatements specifically identified. For example, when the auditor determines that the audit client failed to accrue an unpaid invoice for goods received prior to the end of the period under audit, the identified error is a known misstatement; and

- Likely misstatement – the auditor's best estimate of the total misstatements in the account balances or classes of transactions that the auditor has examined.

AU sec. 312.34 indicates that auditors evaluate misstatements both individually and in the aggregate "to consider whether, in relation to individual amounts, subtotals, or totals in the financial statements, they materially misstate the financial statements taken as a whole." The auditor's evaluation of misstatements should consider both quantitative and qualitative factors.

The auditing standards refer to three primary categories of likely misstatement –

- projected misstatements from sampling applications;

- differences resulting from applying substantive analytical procedures; and

- differences resulting from testing accounting estimates.

For discussion purposes, this briefing paper focuses on the last two categories.

Evaluation of Results of Substantive Analytical Procedures

AU sec. 329, *Analytical Procedures,* defines analytical procedures as "evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data." For example, an auditor may perform an analysis of ratios comparing financial statement information to related operating or production statistics. Substantive analytical procedures are commonly used as tests of accounts or other financial statement components to identify potential misstatements.

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AU secs. 312 and 329 provide direction to auditors on evaluating the results of substantive analytical procedures. Those standards indicate that auditors should evaluate significant differences between recorded amounts and the expected amounts as determined from the analytical procedures.[9/]

AU sec. 329.21 explains the auditor's evaluation of substantive analytical procedures, as follows:

> The auditor should evaluate significant unexpected differences. Reconsidering the methods and factors used in developing the expectation and inquiry of management may assist the auditor in this regard. Management responses, however, should ordinarily be corroborated with other evidential matter. In those cases when an explanation for the difference cannot be obtained, the auditor should obtain sufficient evidence about the assertion by performing other audit procedures to satisfy himself as to whether the difference is a likely misstatement. In designing such other procedures, the auditor should consider that unexplained differences may indicate an increased risk of material misstatement.

The minimum audit procedure for investigating significant unexpected differences is management inquiry. The interim standards provide little direction to help auditors determine what or how much they should do to corroborate management's responses.

[9/] AU sec. 329.17 states, "The expectation should be precise enough to provide the desired level of assurance that differences that may be potential material misstatements, individually or when aggregated with other misstatements, would be identified for the auditor to investigate. As expectations become more precise, the range of expected differences becomes narrower and, accordingly, the likelihood increases that significant differences from the expectations are due to misstatements. The precision of the expectation depends on, among other things, the auditor's identification and consideration of factors that significantly affect the amount being audited and the level of detail of data used to develop the expectation."

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Discussion Questions –

5. Is the direction that "Management responses…should ordinarily be corroborated with other evidential matter" sufficient, or should the auditing standards provide more direction regarding what and how much auditors should do to corroborate management's explanations for significant unexpected differences?

6. If the auditor does not obtain sufficient corroborating evidence regarding a significant unexpected difference, would it be appropriate to treat the uncorroborated difference as a likely misstatement?

Evaluation of Accounting Estimates

Accounting estimates are subjective because they involve uncertain outcomes and require substantial judgment. It is, therefore, possible that legitimate differences will exist between management's and the auditor's opinions about the amount of those estimates. On the other hand, paragraph .63 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit,* states, "Fraudulent financial reporting often is accomplished through intentional misstatement of accounting estimates."

The auditor's responsibilities regarding accounting estimates include consideration of whether the estimates contain misstatements or reflect a management bias that results in material misstatement of the financial statements. These responsibilities require applying professional skepticism and due professional care while recognizing that most estimates cannot be measured with certainty and should reflect management's best judgments in properly applying the accounting standards.

AU sec. 342, *Auditing Accounting Estimates,* provides direction for testing accounting estimates.[10/] AU secs. 312 and 342 provide direction on evaluating the results of tests of accounting estimates.

[10/] This briefing paper focuses on AU secs. 312 and 342, which set forth the general principles for evaluating accounting estimates. Other auditing standards provide direction for auditing certain types of accounting estimates, such as AU sec. 328, *Auditing Fair Value Measurements and Disclosures*. However, the principles of AU secs. 312 and 342 generally are consistent with the direction in the other standards.

AU sec. 342 describes three approaches[11/] to testing accounting estimates –

a) review and test the process used by management to develop the estimate;

b) develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate; and

c) review subsequent events or transactions occurring prior to completion of fieldwork.

Auditors may use one or a combination of these approaches to test a particular accounting estimate.

Misstatements arising from obvious, quantifiable misstatements (e.g., computation errors or clear misapplication of related accounting standards) are known misstatements. Differences between the auditor's judgments and management's judgments about the accounting estimates may result in likely misstatements. According to AU sec. 312.36, when evaluating differences in judgments, the auditor determines whether the difference between the estimated amount best supported by the audit evidence and the estimated amount included in the financial statements is reasonable. If he or she determines that the difference between the estimated amounts is reasonable, that difference is not considered a likely misstatement. However, if the auditor concludes that the estimated amount included in the financial statements is unreasonable, the auditor treats the difference between the recorded estimate and the "closest reasonable estimate" as a likely misstatement.

[11/] A conforming amendment resulting from Auditing Standard No. 2 adds a note to AU sec. 342.10 that states, "When performing an integrated audit of financial statements and internal control over financial reporting, the auditor may use any of the three approaches. However, the work that the auditor performs as part of the audit of internal control over financial reporting should necessarily inform the auditor's decisions about the approach he or she takes to auditing an estimate because, as part of the audit of internal control over financial reporting, the auditor would be required to obtain an understanding of the process management used to develop the estimate and to test controls over all relevant assertions related to the estimate."

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To illustrate, assume that an auditor analyzes problem accounts receivable and recent bad-debt trends and concludes that a reasonable range for an allowance for doubtful accounts is between $5 million and $6.5 million. If the recorded estimate is $6 million, the auditor would typically conclude that the recorded estimate is reasonable because it is within a reasonable range. However, if the recorded estimate is $1 million, the likely misstatement would be $4 million, which is the difference between the recorded estimate ($1 million) and the closest end of the reasonable range ($5 million).[12/]

The interim standards also indicate that the auditor should consider whether the difference between estimates best supported by the audit evidence and the estimates included in the financial statements that are individually reasonable indicate a possible bias on the part of the issuer's management. An effective approach to accomplish that direction in the interim standards is to (a) quantify differences resulting from testing accounting estimates and (b) to aggregate those differences in a way that allows the auditor to make a judgment about the effect of the differences on the financial statements taken as a whole. However, the auditing standards specifically require aggregation of only the portion of the differences in accounting estimates that are outside a reasonable range. Consequently, some auditors might not quantify the difference between management's estimate and the estimate best supported by the audit evidence unless management's estimate is considered unreasonable.

Discussion Question –

7. Should the auditing standards require auditors to quantify and evaluate the differences resulting from testing accounting estimates, including differences that fall within a reasonable range?

Precision of Auditor Judgments about Accounting Estimates

The interim standards provide little direction on how to establish a degree of precision in determining an independent estimate or reasonable range for accounting

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[12/] This example was adapted from an auditing interpretation in paragraph .07 of AU sec. 9312, *Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312*.

estimates.[13/] The precision of the auditor's judgments about accounting estimates[14/] may be enhanced in several ways, including:

- using a point estimate based on the amount best supported by the evidence;
- using a probability-weighted average of potential outcomes;
- using the mid-point of a reasonable range, if no one outcome is more likely than another is; or
- limiting the size of the range, such as at an amount less than tolerable misstatement for that account.

Discussion Question –

8. Should the auditing standards provide more direction regarding the precision of the auditor's judgments about accounting estimates? If so, what direction would be helpful?

Consideration of Management Bias in Accounting Estimates

The interim standards provide the following direction regarding the consideration of management bias in accounting estimates:

- AU sec. 312.36 mentions, "If each accounting estimate included in the financial statements was individually reasonable, but the effect of the difference between each estimate and the estimate best supported by the

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13/ The auditing interpretation in paragraph .06 of AU sec. 9312 defines "closest reasonable estimate" as a range of acceptable amounts or a point estimate, if that is a better estimate than any other amount.

14/ In some circumstances, the auditor might use a firm specialist or engage a specialist to assist in making judgments about the accounting estimates.

audit evidence was to increase income, the auditor should reconsider the estimates taken as a whole."

- An auditing interpretation in paragraph .09 of AU sec. 9312, *Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312,* states, "In these circumstances [described in AU sec. 312.36], the auditor should reconsider whether other recorded estimates reflect a similar bias and should perform additional audit procedures that address those estimates. In addition, the auditor should be alert to the possibility that management's recorded estimates were clustered at one end of the range of acceptable amounts in the preceding year and clustered at the other end of the range of acceptable amounts in the current year, thus indicating the possibility that management is using swings in accounting estimates to offset higher or lower than expected earnings. If the auditor believes that such circumstances exist, the auditor should consider whether these matters should be communicated to the entity's audit committee, as described in AU sec. 380, *Communication With Audit Committees*, paragraphs .08 and .11."

- AU sec. 316.64 requires the auditor to perform a retrospective review of accounting estimates to assess possible management bias.

- AU sec. 316.65 indicates that, if the auditor identifies a possible management bias in accounting estimates, he or she should evaluate whether circumstances producing that bias represent a risk of material misstatement due to fraud.

The interim auditing standards provide little direction on how the auditor should consider management bias or possible bias when evaluating whether the financial statements are presented in accordance with generally accepted accounting principles.

The auditing standards could provide direction that the auditor should accumulate the differences between management's estimate and the estimate best supported by the audit evidence and obtain an understanding of the nature and cause of the difference(s), including consideration of potential management bias. After obtaining an understanding of the nature and cause of the differences in accounting estimates and performing any other procedures considered necessary, if the auditor still

believes that the differences in accounting estimates are material, either individually or in the aggregate, he or she could ask management to re-evaluate its accounting estimates and adjust them such that the differences in accounting estimates are no longer material. Then, if sufficient adjustments are not made, the auditor would consider the effect on his or her auditor's report.[15/]

Discussion Question –

9. Should the auditing standards provide more direction on how to evaluate the possibility of management bias in accounting estimates and its effect on the financial statements? What is your advice on the nature and extent of that direction?

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[15/] In an integrated audit, material differences in accounting estimates also might lead auditors to re-evaluate the effectiveness of the controls over those estimates.