
STANDING ADVISORY GROUP MEETING

RISK ASSESSMENT IN FINANCIAL STATEMENT AUDITS

February 16, 2005

Introduction

The Standing Advisory Group ("SAG") will discuss several issues central to a project on risk assessment in financial statement audits. This briefing paper provides background information about current practices and auditing standards relating to risk assessment, factors to be evaluated in developing new auditing standards for risk assessment, and possible approaches to some of the key issues.

Background

In general, risk assessment can be described as a process whereby the auditor evaluates the risk that material misstatement will occur and then plans and performs his or her audit based on those evaluations. This concept has been embodied in the auditing standards for many years. The interim auditing standards discuss it specifically in AU section 312,^{1/} *Audit Risk and Materiality*. (See Appendix B.) That standard describes audit risk at two levels, the overall financial statement level and the account

^{1/} References to AU sections throughout this paper are to the Board's interim standards adopted as in existence on April 16, 2003, except as superseded or amended by the Board. These standards may be found on the PCAOB's Web site at www.pcaobus.org.

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

STANDING ADVISORY GROUP MEETING

level. AU section 312 also describes three components of audit risk^{2/} at the account level—

- *Inherent risk*—the susceptibility of an assertion^{3/} to a material misstatement, assuming that there are no related controls.
- *Control risk*—the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the company's internal control.
- *Detection risk*—the risk that the auditor's procedures will not detect a material misstatement that exists in an assertion.

Inherent and control risks are the audited company's risks; the auditor merely evaluates those risks as they exist. In contrast, detection risk is managed by the auditor through his or her audit procedures. As the scope and effectiveness of the procedures increase, detection risk decreases.

The interim auditing standards on assessing risk and responding to it are, with a few exceptions, written in broad terms without much definitive guidance. For example, AU section 312 indicates that auditors may assess inherent and control risk at the maximum if they find it "more efficient,"^{4/} and it states only that the auditor should have a reasonable basis for assessing inherent and control risk below maximum.

^{2/} Audit risk is the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated.

^{3/} Assertions are representations by management that are embodied in financial statement components, such as the valuation of inventory or completeness of recorded liabilities.

^{4/} The lower the assessed level of inherent or control risk for an assertion, the less the need for evidence from direct tests of accounts and other financial statement components (that is, substantive procedures, such as tests of the details that comprise specific financial statement amounts, may be decreased). However, to assess inherent and control risks below the maximum the auditor must obtain and

STANDING ADVISORY GROUP MEETING

More specific guidance can be found for assessing control risk in AU section 319, *Consideration of Internal Control in a Financial Statement Audit*, of the interim standards. AU section 316, *Consideration of Fraud in a Financial Statement Audit*, provides guidance about the assessment of the risk of material misstatement due to fraud.

Traditionally, auditors have focused primarily on the accounts comprising the financial statements, and risk was assessed based on the accounts' size, characteristics, and related controls. During the 1990's, many auditors moved away from audit approaches that focused narrowly on financial statement accounts toward broader based audit approaches, which are sometimes labeled as "risk-based auditing" or "business risk auditing." Under these newer methodologies, auditors take a more holistic view of the business, including reviewing business strategies and processes, internal and external factors, and performance measurement practices to identify risks of material misstatement. Then the auditors devote the most audit attention to the higher risk areas. Auditors who follow this approach are referred to hereafter as risk-based auditors.

Supporters of risk-based auditing believe that it is more effective because (a) auditors develop a greater understanding of the companies, their environments, and business processes and (b) their audit procedures are more targeted to the areas that are more likely prone to material misstatement.

Critics of risk-based auditing have expressed concerns about its effectiveness. They assert that auditors may not obtain a sufficient understanding of the company and its environment to identify the risks of material misstatement adequately and that auditors may not obtain sufficient evidence to support their risk assessments or sufficiently test financial statement accounts and disclosures.

evaluate more information about risks that could affect the financial statements and perform tests of the effectiveness of controls. Thus, assessing risk at the maximum is considered to be "more efficient" if the audit effort needed to obtain evidence that supports a lower level of assessed risk exceeds the time to be saved from reducing substantive procedures permitted by the lower assessed level of risk. This, of course, assumes that assessing risk at the maximum as an "efficiency" measure is equally effective, which is not always true.

STANDING ADVISORY GROUP MEETING

The Public Oversight Board's Panel on Audit Effectiveness ("PAE") considered both the conceptual framework regarding audit risk (commonly known as the "audit risk model") and the effectiveness of risk-based audits as part of its work. In its report, *The Panel on Audit Effectiveness Report and Recommendations*,^{5/} the PAE concluded that the existing conceptual framework for assessing audit risk continues to be a valid and appropriate basis for performing audits of financial statements. The PAE's report also supported some of the basic concepts embedded in the risk-based auditing methodologies. However, the PAE's recommendations reflected concerns that the application of the audit risk framework should be strengthened and that auditing standards need to be more definitive. Appendix A summarizes the PAE's key recommendations in those areas.

In 2000, a Joint Working Group, consisting of standard setters and academics from Canada, the United Kingdom and the United States published the results of a research project on current developments and audit methodologies of the large firms. That group also endorsed the audit risk model and highlighted benefits of the risk-based audit approach.

More recently, the International Auditing and Assurance Standards Board ("IAASB") and Auditing Standards Board ("ASB") have undertaken a joint project to revise their respective auditing standards relating to the auditor's risk assessment process. The IAASB issued its new risk assessment standards in 2004, and the ASB is developing a suite of Statements on Auditing Standards relating to risk assessment.

The staff believes that audit quality can be improved by developing new definitive auditing standards regarding the auditor's risk assessment process and the appropriate audit response to those risks.

Phases of Risk Assessment Process

In practice, the auditor's risk assessment process is dynamic, and auditor judgments and procedures are refined as more evidence is obtained. However, for

^{5/} Public Oversight Board, *The Panel on Audit Effectiveness Report and Recommendations* (August 31, 2000).

STANDING ADVISORY GROUP MEETING

discussion purposes, it is useful to think of the auditor's risk assessment process^{6/} as a linear progression consisting of the following phases:

1. *Risk identification.* The auditor evaluates what can go wrong with the financial statements based on his or her understanding of the company, its industry and environment, and its business processes.
2. *Risk analysis (assessment).* The auditor analyzes the risks that he or she identified and evaluates how they might affect the financial statements.
3. *Auditor response.* The auditor decides how to conduct the audit in light of the identified risks, so he or she obtains a high level of assurance that material misstatements will be detected.

Risk Identification

During the risk identification phase, the auditor obtains an understanding of the company, industry, and environment to identify risks that could materially affect the financial statements and related disclosures. Risks may be pervasive (such as a weak control environment) or may relate to only one or two accounts or assertions (such as credit risks affecting the collectibility of receivables).

The interim auditing standards already provide for several procedures that typically would be performed during the risk identification phase. The following are a few examples of those procedures:

- Obtaining knowledge of the company's business and its use of information technology in significant accounting applications. (AU section 311, *Planning and Supervision*).
- Obtaining an understanding of the company's internal control (AU section 319)

^{6/} The description of the risk assessment process used in this briefing paper is a general one to facilitate discussion of the underlying concepts. This description may or may not be adopted by the Board during development of the related auditing standards. In some respects, this description differs from those in the risk assessment standards of the IAASB and proposed standards of the ASB.

STANDING ADVISORY GROUP MEETING

- Performing preliminary analytical procedures^{7/} (paragraphs .06-.08 of AU section 329, *Analytical Procedures*)
- Brainstorming among engagement team members about where the financial statements might be susceptible to fraud, obtaining information needed to identify risks of material misstatement due to fraud, and identifying those risks (AU section 316)

A key factor in the effectiveness of any audit approach, especially a risk-based audit approach, is the auditor's ability to identify the risks that could result in material misstatement of the financial statements. If the auditor fails to identify a significant risk, he or she may not perform sufficient audit procedures to detect material misstatements resulting from that risk. Effective risk identification requires an understanding of the business and industry. The report of the Commission on Auditors' Responsibilities (the Cohen Commission^{8/}) stated that:

Independent auditors recognize that an understanding of a client's business and the industry of which it is a part is critical to a proper audit. The required knowledge encompasses economic conditions, inherent internal control problems, and peculiarities of the industry. Although virtually all auditors would agree that having knowledge of a company and its industry is a necessary condition for a proper audit, that responsibility is not explicitly recognized in professional standards. Current professional standards provide the auditor little guidance on how to fulfill that responsibility. Consequently, the standard of professional skill and care should be sharpened to require specifically that the auditor have an understanding of the nature of the business of the company under examination, its methods of operations, and significant practices and regulatory requirements peculiar to the company or the industry of which it is a part. The Commission's research indicated that lack of knowledge of

^{7/} Analytical procedures involve comparisons of financial statement information to other financial and non-financial information, such as comparing inventory turnover rates over several periods of time.

^{8/} The Commission on Auditors' Responsibilities, *Report, Conclusions, And Recommendations* (1978).

STANDING ADVISORY GROUP MEETING

a client's business or industry was often a problem. Awareness of specific financial and business-related risks of a company is essential to the application of informed judgment necessary for a proper audit. Thus, independent auditors should make every effort to acquire all readily available knowledge that might lead to perception of substantial financial or business-related risks deliberately or unwittingly accepted by the company under examination.

There are several ways to obtain an understanding of the company and its environment, as well as to identify risks that could potentially affect the financial statements. The following are examples of topics that an auditor might obtain information about during the risk identification phase:

- Industry factors (such as competition, industry trends, profit and growth drivers, major industry vulnerabilities and threats, and industry accounting practices)
- Other external factors (such as economic conditions, taxation and regulatory issues, and relevant trends in commodities or financial markets)
- Company factors –
 - Operating characteristics (such as, organizational structure, management, locations, products and services, product life cycle, major costs and expenses, significant assets and liabilities, key suppliers and customers, labor, and related parties)
 - Capital structure (such as debt and equity capital, derivatives, and off-balance-sheet financing)
 - Strategic issues (such as how the company competes and major business initiatives)
 - Business and financial reporting processes (such as characteristics, issues, new processes, use of technology)
 - Other financial reporting issues (such as, significant accounting policies; complex or subjective accounting issues, including

STANDING ADVISORY GROUP MEETING

contingent liabilities and accounting estimates; past financial reporting difficulties; new accounting standards; new acquisitions, transactions, or lines of business; and changes in financial reporting systems)

- Financial performance (such as, trends in financial condition or operating performance, key performance indicators, budgets and forecasts, and reports of analysts and credit rating agencies)
- Internal control (including changes or deficiencies in internal control)

Many risk-based auditors have established proprietary methodologies for identifying risks. Also, many professionals other than independent auditors also are concerned with business risk. For example, credit rating agencies and financial analysts perform their own fundamental analyses to evaluate risks relating to issuers. Institutional investors consider the risks associated with a particular company when making investment decisions. Corporate financial professionals and attorneys examine risks, for example, when investigating potential acquisitions. Regulatory agencies evaluate risks associated with regulated entities. To the extent that others' risk evaluation methodologies are concerned with the reliability of financial reporting, those risks could be relevant to financial statement auditors.

Discussion Questions –

1. What would an auditor need to do to obtain an adequate understanding of the company and environment to identify risks that could result in material misstatement of the financial statements? When answering this question, please consider situations involving new clients about which the firm (or office) has little or no relevant industry expertise.
2. Are there any additional risk factors or sources of information about risk analysis that you would recommend for consideration in developing standards for auditors of financial statements?

STANDING ADVISORY GROUP MEETING

Risk Analysis (Assessment)

During the risk analysis phase, the auditor reviews the risks he or she has identified and evaluates the potential effects on the financial statements. There are two basic components of this assessment—

- a. The level of the identified risks, considering the pervasiveness and magnitude of the effect on the financial statements and the likelihood that they will occur (that is, inherent risk)
- b. The risk that any mitigating controls might fail (that is, control risk)

Collectively, these two components represent the risk that a material misstatement of the financial statements would occur. Thus, this combination of risks is referred to as the risk of material misstatement (ROMM). Some auditors assess inherent risk and control risk individually, and they may then combine them to arrive at an assessment of misstatement risk. Other auditors assess only the combined ROMM. To facilitate the discussion, this briefing paper addresses inherent risk, control risk, and ROMM separately.

Inherent Risk Assessment

The interim auditing standards state that auditors should assess audit risk (which includes inherent risk) at both the overall financial statement level and the account balance/transaction class level. The interim standards also indicate that the auditor should have an appropriate basis for assessing inherent risk below the maximum, and they permit auditors to assess inherent risk as maximum if it is "more efficient" to do so.

Beyond those statements, the interim auditing standards provide little direction regarding the procedures that auditors must perform to assess inherent risk. Most of the guidance in those standards is provided to influence the auditor's thought process when making judgments about the level of risk.^{9/} For example, AU section 312 states

^{9/} Inherent risk relates to the risk of material misstatement due to errors or fraud. Thus, inherent risk is affected by the risk of material misstatement due to fraud. AU section 316, *Consideration of Fraud in a Financial Statement Audit*, of the interim auditing standards provides guidance on the auditor's procedures with respect to the

STANDING ADVISORY GROUP MEETING

that complex calculations are more likely to be misstated than simple calculations, and cash is more susceptible to theft than an inventory of coal.

In practice, risk-based auditors may assess inherent risk by analyzing the business risks and determining their potential effects on the financial statements. This would include contemplation of the accounts and assertions that might be affected, the likelihood of misstatement, and the amount of the potential misstatement.

The PAE Report concluded that the guidance and practices with respect to inherent risk need strengthening. The PAE also noted during their study of SEC Accounting and Auditing Enforcement Releases (AAERs) several instances in which the company's inherent risk apparently increased as a result of significant changes in its business, but the auditors apparently did not assess accurately how those changes increased inherent risk. Appendix A summarizes key PAE recommendations.

From an audit quality perspective, the primary areas of concern relating to the auditor's assessment of inherent risk using a risk-based audit approach are as follows:

- Inadequate analysis of the effects of identified risks, that is, what could go wrong with the financial statements
- Inadequate analysis of risks associated with significant accounts
- Assessment of inherent risk at a level that is too low, based on underestimating the magnitude, pervasiveness, or likelihood of misstatement

As a practical matter, an auditor ordinarily will not have the depth of understanding of the business, its industry, and its environment necessary to manage the company. Thus, the auditor might not be able to identify all potential business risks. Auditors may compensate for this by assessing risks for relevant assertions of

risk of material misstatement due to fraud. The Board likely would address financial fraud as a separate project.

STANDING ADVISORY GROUP MEETING

significant accounts that are not associated with identified business risks and performing substantive procedures^{10/} relating to those accounts.

For auditors who do not use a risk-based audit approach, the primary concern is that auditors may assess inherent risk as maximum without attempting to understand and evaluate the types of risks affecting the financial statements (that is, exactly how the financial statements could be materially misstated).

One approach to a proposed new auditing standard for inherent risk assessment would be to require the auditor to—

- a. Evaluate the potential effects of the identified risks on the financial statements, that is, what could go wrong with the financial statements and what accounts and disclosures would be affected,
- b. Assess the level of risk for identified risks, based on the potential magnitude and likelihood of misstatement,
- c. Have an appropriate basis for that risk assessment, and
- d. Document items a. through c.

A similar requirement would apply to relevant assertions of significant accounts that are not related to identified risks.

One advantage to the preceding approach is that the assessed level of risk could help the auditor determine his or her tests of mitigating controls. For example, the greater the likelihood or magnitude of the identified risk, the more effective the controls must be to mitigate that risk, and the more evidence the auditor should obtain to assess the effectiveness of the mitigating controls.

Similarly, an advantage of requiring assessment of inherent risk for relevant assertions of significant accounts is to help the auditor ensure that he or she adequately evaluates the risks associated with the accounts as well as the identified business risks. For example, the auditor might not identify any business risks relating to the

^{10/} Substantive procedures are direct tests of accounts and other financial statement components. They include analytical procedures and detailed testing procedures such as confirming accounts receivable.

STANDING ADVISORY GROUP MEETING

understatement of accounts payable, but the area might be assessed as high risk because of its nature and potential to materially affect the financial statements.

Discussion Questions –

3. Should auditors be required to assess and document the level of risk (as described above) for each identified risk and relevant assertions of all significant accounts?
4. How much weight can be given to global factors, such as industry conditions or management integrity and competence, in assessing inherent risk at the account level (that is, can global factors serve only to increase the assessed level of risk, or can they also reduce it)?

Control Risk Assessment

PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With An Audit of Financial Statements*, provides direction for audits of internal control in integrated audits, and certain provisions of that standard also apply to assessing control risk in the financial statement portion of the audit. For example, Auditing Standard No. 2 encourages auditors to assess control risk as low in the financial statement portion of an integrated audit, in that the standard requires the auditor to document why the auditor has assessed control risk as other than low for circumstances in which the auditor has concluded that internal control is effective for the internal control portion of the audit. However, the work necessary to assess control risk for particular financial statement assertions in the financial statement portion of an integrated audit might be different than the work required solely to opine on the effectiveness of internal control, as required by Section 404 of the Sarbanes-Oxley Act of 2002 and Auditing Standard No. 2. Specifically, an audit of internal control over financial reporting is directed to the effectiveness of internal control only as of a point in time, while the testing necessary to assess control risk in the financial statement portion of an integrated audit must be directed to the period of time over which the auditor intends to rely on the control.

The interim auditing standards (AU section 319), as amended by Auditing Standard No. 2, describe the process for assessing control risk during a financial statement audit. Under AU section 319, the auditor must test the design and operating effectiveness of internal control to assess control risk below the maximum.

STANDING ADVISORY GROUP MEETING

Alternatively, AU section 319 allows the auditor to omit tests of controls if it is "more efficient" merely to assess control risk as maximum.

If the auditor plans to rely on controls to assess control risk below the maximum under AU Section 319, he or she can test the effectiveness of only those controls that he or she has determined to correspond to and mitigate the related risks.^{11/} Historically, some auditors have elected to primarily test company-level controls (such as, the control environment, governance, and monitoring of business processes) that could be evaluated through inquiry and observation. Also, AU section 319 allows auditors to use evidence obtained in prior audits to assess control risk in a current audit, depending on conditions and limitations set forth in those standards. Thus, an auditor might theoretically assess control risk below the maximum during the current audit based by and large on tests of controls performed in a prior audit.

The PAE identified ways to improve the control risk assessment process in financial statement audits, and Appendix A summarizes its key recommendations. From an audit quality perspective, the primary concern is assessing control risk too low for reasons such as—

- Relying on controls that were not effective enough, for example, relying too much on company-level controls or other controls that are not designed or operating well enough to support the control risk assessment
- Inadequately testing controls, for example, using insufficient sample sizes, testing controls over an inappropriately short period of time, or relying too much on evidence from prior audits
- Incorrectly evaluating the results of tests of controls performed, for example, dismissing test exceptions without adequate follow-up and examination

Another area of concern, especially for auditors who assess control risk at the maximum for efficiency purposes, is failing to consider control risk adequately in planning and performing substantive procedures. For example, the interim auditing

^{11/} In an audit of internal control under Auditing Standard No. 2, the auditor must obtain evidence about the effectiveness of controls over all relevant assertions related to all significant accounts and disclosures in the financial statements.

STANDING ADVISORY GROUP MEETING

standards indicate that for circumstances in which a significant amount of information supporting one or more financial statement assertions is electronically initiated, recorded, processed, or reported, it may not be possible to design substantive procedures that by themselves provide enough evidence that the assertions are not materially misstated. In those situations, the auditor should perform tests of controls to gather evidential matter to use in assessing control risk.

Certain provisions of Auditing Standard No. 2 apply specifically to audits of internal control, but they also could be considered for assessing control risk in financial statement audits. For example, the Standard limits the auditor's reliance on inquiry and observation procedures as support for his or her conclusion about control effectiveness. Also, each audit of internal control must stand on its own, which prohibits "rotation of controls" in those audits.

Discussion Questions –

5. Should auditors be required to test controls in each audit of the financial statements? If so, what types of controls should be tested (such as, controls designed to mitigate identified risks, controls over relevant assertions of significant accounts, or only controls that result in greater audit efficiency)?
6. Should rotation of tests of controls from year to year be prohibited, or should it be permitted under certain conditions? If permitted, under what conditions should rotation be allowed?

Risk of Material Misstatement

The risk of material misstatement (ROMM) is a function of inherent risk and control risk. The AICPA audit guide, *Audit Sampling*, as well as many auditing textbooks and audit sampling tools provide methods for quantifying ROMM for sampling purposes. However, the auditor's assessment of risk of material misstatement is normally a qualitative judgment.

A risk-based auditor may evaluate an identified risk in combination with mitigating controls and arrive at an assessment of remaining "residual risk" that would be equivalent to ROMM.

STANDING ADVISORY GROUP MEETING

From an audit quality perspective, the primary concerns regarding the assessment of ROMM are—

- Inconsistencies in evaluating ROMM, for example, assessing ROMM differently in similar situations
- Assessing ROMM too low, for example, giving too much weight to either the inherent or control risk components or failing to consider qualitative as well as quantitative factors

One approach to auditing standards relating to ROMM assessment is to require auditors to document a specific assessment of ROMM for identified risks and relevant assertions of significant accounts. This assessment should be based on a reasonable methodology developed by the auditor that (a) can be applied consistently across audit engagements and (b) considers both qualitative and quantitative aspects of risk.

One of the benefits of arriving at a specific assessment of ROMM is that the risk level provides a context for the auditor to determine the level of audit response that will be needed. For example, the higher the risk of material misstatement relating to the valuation of an intangible asset, the more relevant and reliable evidence the auditor would be expected to obtain to support the auditor's conclusion about the asset valuation.

Similarly, an advantage of assessing ROMM for relevant assertions of significant accounts is that it can help the auditor focus his or her audit attention toward those accounts and assertions that are more prone to material misstatement based on their nature and materiality to the financial statements.

Discussion Question –

7. Should auditors be required to document a specific assessment of ROMM for identified risks and relevant assertions of significant accounts using a methodology that can be applied consistently and that considers both qualitative and quantitative aspects of risk? Why or why not?

Auditor Response to Risk Assessment

Based on the auditor's risk identification and assessment procedures, the auditor develops a response, which refers to the way the remaining audit procedures are

STANDING ADVISORY GROUP MEETING

planned and conducted. There are two potential levels of audit response: overall response and response at the assertion level.

An overall response may be appropriate anytime, but it is especially needed when identified risks are pervasive. An overall response to pervasive risks might include, for example—

- Emphasizing the importance of professional skepticism
- Assigning personnel to the engagement who have more experience or specialized skills
- Increasing the level of supervision and review of the engagement team
- Making global decisions about the nature, timing, and extent of substantive procedures

A response at the assertion level refers to the substantive procedures used and how they are applied. This process generally is described as the nature, timing, and extent of audit procedures. *Nature* of the procedures refers to the types of substantive procedures the auditor performs. *Timing* refers to when (or how often) the auditor performs the procedures. *Extent* refers to the quantity of the procedures that the auditor performs (such as, sample sizes). Generally, as the risk increases for an assertion, the auditor should design and perform procedures that—

- Provide evidence that is more relevant and reliable
- Are performed closer to the date of the financial statements instead of an interim date
- Provide more evidence (generally, through more extensive procedures)

Risk-based auditors generally design their audits so that relatively more audit attention is devoted to the accounts and assertions that are evaluated as having greater risk. Material accounts and assertions that are deemed to be lower risk are not tested as extensively as the higher-risk areas. For example, lower-risk areas may be subjected only to analytical procedures. Accounts that are assessed as low-risk and

STANDING ADVISORY GROUP MEETING

individually immaterial might be passed entirely or subjected only to very high level analytical procedures.

Linkage of risk assessments to an appropriate audit response has proven to be challenging for auditors. For example, the PAE report noted problems with linkage of risk assessments to resulting audit procedures when applying AU section 316A^{12/} on consideration of fraud in a financial statement audit.

It is likely that an approach to developing auditing standards that promotes better linkage between risk assessments and audit responses will involve a combination of the following elements:

- Guidelines for determining the minimum audit procedures for identified risks, significant accounts, and other accounts based on the nature of the accounts and risks, as well as the assessed level of risk. These guidelines would consider the nature, timing, and extent of the audit procedures to be performed.
- More specific documentation requirements. For example, auditors might be required to (a) document their response to each identified risk and risk assessments for specific accounts, and (b) demonstrate through appropriate documentation how the auditor's responses were adequate and appropriate for his or her risk assessments.
- Examples and case studies describing how auditors might respond to various risk assessment scenarios.

Under this approach, the auditor's procedures would address specifically both (a) accounts and assertions affected by identified risks and (b) relevant assertions of other significant accounts.

Discussion Questions –

8. Should some or all of the proposed elements— guidelines for determining minimum audit procedures, more definitive documentation requirements,

^{12/} AU section 316A, *Consideration of Fraud in a Financial Statement Audit*, was subsequently superseded by AU section 316, with the same title.

STANDING ADVISORY GROUP MEETING

and examples and case studies—be incorporated into auditing standards regarding linkage between risk assessments and audit responses? Why or why not? Are there other elements that should be included?

Other Recommendations

9. Do you disagree with any of the PAE recommendations listed in Appendix A? If so why?
10. What other advice do you have relating to consideration of auditing standards for risk assessment (suggestions, practice issues, etc.)?

* * *

The PCAOB is a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.

STANDING ADVISORY GROUP MEETING

APPENDIX A

Summary of Key Recommendations from the Panel on Audit Effectiveness Regarding Risk Assessment^{13/}

Audit Risk (General)

- Auditing standards should require auditors to possess a far deeper understanding of the company's business processes, risks, and controls.
- Auditing standards should require auditors to consider published analysts' reports and forecasts (in addition to other information) while gaining an understanding of the company's business and industry and assessing risks.

Inherent Risk Assessment

- Auditing standards should require the auditor to make inherent risk assessments for significant account balances and classes of transactions by evaluating what could go wrong at the individual assertion level.
- No longer permit the auditor to default to assessing inherent risk at the maximum for efficiency or other reasons without evaluating what could go wrong in specific financial statement assertions.
- Provide additional guidance regarding the factors that affect inherent risk, including the company's business processes and risks, and the depth of the auditor's understanding of those factors.
- Indicate the depth of auditor knowledge and the nature of activities or procedures (and provide some examples of such activities or procedures) that the auditor might perform to support assessing inherent risk (at both the financial statement and account or class of transactions levels) below the maximum.

^{13/} Adapted from Public Oversight Board, *The Panel on Audit Effectiveness Report and Recommendations* (August 31, 2000).

STANDING ADVISORY GROUP MEETING

Control Risk Assessment

- Auditing standards should provide more specific guidance on:
 - The required depth of auditor knowledge and understanding about internal control.
 - Whether and to what extent auditors may rely on their assessments of the effectiveness of the control environment (including corporate governance) and management's high-level monitoring of the business to support control risk assessments below the maximum.
 - The nature and extent of documentation needed, particularly to support the auditor's consideration of internal control in planning the audit and in assessing control risk.
 - The circumstances, if any, in which auditors may rely entirely on substantive procedures with either no reliance on controls or reliance only at the control environment level.
 - Identifying and focusing on key controls for the purpose of determining what could go wrong and what controls to test.
 - Linking the "components of internal control," including transaction-level controls, with identified risks and substantive procedures.
 - The nature, timing and extent of controls testing in varying circumstances.
 - The circumstances, if any, permitting rotating tests of controls over two or more years in areas in which the auditor intends to rely on controls.
 - The circumstances, if any, in which tests of controls also may constitute substantive procedures (dual purpose tests).
 - The necessary level of testing of management reports and other internal data sources used by the auditor in performing analytical procedures or other audit procedures

STANDING ADVISORY GROUP MEETING

APPENDIX B

AU Section 312

Audit Risk and Materiality in Conducting an Audit^{fn.*}

(Note: Conforming amendments to Auditing Standard No. 2, AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING PERFORMED IN CONJUNCTION WITH AN AUDIT OF FINANCIAL STATEMENTS, are shown in italics.)

.01 This section provides guidance on the auditor's consideration of audit risk and materiality when planning and performing an audit of financial statements in accordance with generally accepted auditing standards. Audit risk and materiality affect the application of generally accepted auditing standards, especially the standards of field work and reporting, and are reflected in the auditor's standard report. Audit risk and materiality, among other matters, need to be considered together in determining the nature, timing, and extent of auditing procedures and in evaluating the results of those procedures.

.02 The existence of audit risk is recognized in the description of the responsibilities and functions of the independent auditor that states, "Because of the nature of audit evidence and the characteristics of fraud, the auditor is able to obtain reasonable, but not absolute, assurance that material misstatements are detected." ^{fn.1} Audit risk ^{fn.2} is the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. ^{fn.3} [As amended, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

.03 The concept of materiality recognizes that some matters, either individually or in the aggregate, are important for fair presentation of financial statements in conformity with generally accepted accounting principles, ^{fn.4} while other matters are not important. The representation in the auditor's standard report regarding fair presentation, in all material respects, in conformity with generally accepted accounting principles indicates the auditor's belief that the financial statements taken as a whole are not materially misstated. [As amended, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82. Revised,

STANDING ADVISORY GROUP MEETING

October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 22-23 of PCAOB Auditing Standard No. 2 regarding materiality considerations.

.04 Financial statements are materially misstated when they contain misstatements whose effect, individually or in the aggregate, is important enough to cause them not to be presented fairly, in all material respects, in conformity with generally accepted accounting principles. Misstatements can result from errors or fraud. ^{fn 5} [As amended, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

.05 In planning the audit, the auditor is concerned with matters that could be material to the financial statements. The auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by errors or fraud, that are not material to the financial statements are detected. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

Note: An integrated audit of financial statements and internal control over financial reporting is not designed to detect deficiencies in internal control over financial reporting that, individually or in the aggregate, are less severe than a material weakness.

.06 The term *errors* refers to unintentional misstatements or omissions of amounts or disclosures in financial statements. Errors may involve—

- Mistakes in gathering or processing data from which financial statements are prepared.
- Unreasonable accounting estimates arising from oversight or misinterpretation of facts.
- Mistakes in the application of accounting principles relating to amount, classification, manner of presentation, or disclosure. ^{fn 6}

STANDING ADVISORY GROUP MEETING

[Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

.07 Although *fraud* is a broad legal concept, the auditor's interest specifically relates to fraudulent acts that cause a misstatement of financial statements. Two types of misstatements are relevant to the auditor's consideration in a financial statement audit—misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets. These two types of misstatements are further described in section 316, *Consideration of Fraud in a Financial Statement Audit*. The primary factor that distinguishes fraud from error is whether the underlying action that results in the misstatement in financial statements is intentional or unintentional. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 24-26 of PCAOB Auditing Standard No. 2 regarding fraud considerations.

.08 When considering the auditor's responsibility to obtain reasonable assurance that the financial statements are free from material misstatement, there is no important distinction between errors and fraud. There is a distinction, however, in the auditor's response to detected misstatements. Generally, an isolated, immaterial error in processing accounting data or applying accounting principles is not significant to the audit. In contrast, when fraud is detected, the auditor should consider the implications for the integrity of management or employees and the possible effect on other aspects of the audit. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

.09 When concluding as to whether the effect of misstatements, individually or in the aggregate, is material, an auditor ordinarily should consider their nature and amount in relation to the nature and amount of items in the financial statements under audit. For example, an amount that is material to the financial statements of one entity may not be material to the financial statements of another entity of a different size or nature. Also, what is material to the financial statements of a particular entity might change from one period to another. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

STANDING ADVISORY GROUP MEETING

.10 The auditor's consideration of materiality is a matter of professional judgment and is influenced by his or her perception of the needs of a reasonable person who will rely on the financial statements. The perceived needs of a reasonable person are recognized in the discussion of materiality in Financial Accounting Standards Board Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*, which defines materiality as "the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement." That discussion recognizes that materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

.11 As a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue. ^{fn.7} [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

Planning the Audit

.12 The auditor should consider audit risk and materiality both in (a) planning the audit and designing auditing procedures and (b) evaluating whether the financial statements taken as a whole are presented fairly, in all material respects, in conformity with generally accepted accounting principles. The auditor should consider audit risk and materiality in the first circumstance to obtain sufficient competent evidential matter on which to properly evaluate the financial statements in the second circumstance. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 22-23 and 39 of PCAOB Auditing Standard No. 2 regarding materiality and planning considerations, respectively.

STANDING ADVISORY GROUP MEETING

Considerations at the Financial Statements Level ^{fn.8]}

.13 The auditor should plan the audit so that audit risk will be limited to a low level that is, in his or her professional judgment, appropriate for expressing an opinion on the financial statements. Audit risk may be assessed in quantitative or nonquantitative terms. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

.14 Section 311, *Planning and Supervision*, requires the auditor, in planning the audit, to take into consideration, among other matters, his or her preliminary judgment about materiality levels for audit purposes. ^{fn.9} That judgment may or may not be quantified. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

.15 According to section 311, the nature, timing, and extent of planning and thus of the considerations of audit risk and materiality vary with the size and complexity of the entity, the auditor's experience with the entity, and his or her knowledge of the entity's business. Certain entity-related factors also affect the nature, timing, and extent of auditing procedures with respect to specific account balances and classes of transactions and related assertions. (See paragraphs .24 through .33.) [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

.16 An assessment of the risk of material misstatement (whether caused by error or fraud) should be made during planning. The auditor's understanding of internal control may heighten or mitigate the auditor's concern about the risk of material misstatement. ^{fn.10} In considering audit risk, the auditor should specifically assess the risk of material misstatement of the financial statements due to fraud. ^{fn.11} The auditor should consider the effect of these assessments on the overall audit strategy and the expected conduct and scope of the audit. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

.17 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. The knowledge, skill, and ability of personnel assigned significant engagement responsibilities should be commensurate with the

STANDING ADVISORY GROUP MEETING

auditor's assessment of the level of risk for the engagement. Ordinarily, higher risk requires more experienced personnel or more extensive supervision by the auditor with final responsibility for the engagement during both the planning and the conduct of the engagement. Higher risk may cause the auditor to expand the extent of procedures applied, apply procedures closer to or as of year end, particularly in critical audit areas, or modify the nature of procedures to obtain more persuasive evidence. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

.18 In an audit of an entity with operations in multiple locations or components, the auditor should consider the extent to which auditing procedures should be performed at selected locations or components. The factors an auditor should consider regarding the selection of a particular location or component include (a) the nature and amount of assets and transactions executed at the location or component, (b) the degree of centralization of records or information processing, (c) the effectiveness of the control environment, particularly with respect to management's direct control over the exercise of authority delegated to others and its ability to effectively supervise activities at the location or component, (d) the frequency, timing, and scope of monitoring activities by the entity or others at the location or component, and (e) judgments about materiality of the location or component. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to Appendix B, "Additional Performance Requirements and Directions; Extent-of-Testing Examples," of PCAOB Auditing Standard No. 2 for considerations when a company has multiple locations or business units.

.19 In planning the audit, the auditor should use his or her judgment as to the appropriately low level of audit risk and his or her preliminary judgment about materiality levels in a manner that can be expected to provide, within the inherent limitations of the auditing process, sufficient evidential matter to obtain reasonable assurance about whether the financial statements are free of material misstatement. Materiality levels include an overall level for each statement; however, because the statements are interrelated, and for reasons of efficiency, 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. For example, if the auditor believes that misstatements aggregating approximately \$100,000 would have a

STANDING ADVISORY GROUP MEETING

material effect on income but that such misstatements would have to aggregate approximately \$200,000 to materially affect financial position, it would not be appropriate for him or her to design auditing procedures that would be expected to detect misstatements only if they aggregate approximately \$200,000. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

.20 The auditor plans the audit to obtain reasonable assurance of detecting misstatements that he or she believes could be large enough, individually or in the aggregate, to be quantitatively material to the financial statements. Although the auditor should be alert for misstatements that could be qualitatively material, it ordinarily is not practical to design procedures to detect them. Section 326, *Evidential Matter*, states that "an auditor typically works within economic limits; his or her opinion, to be economically useful, must be formed within a reasonable length of time and at reasonable cost." [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

.21 In some situations, the auditor considers materiality for planning purposes before the financial statements to be audited are prepared. In other situations, planning takes place after the financial statements under audit have been prepared, but the auditor may be aware that they require significant modification. In both types of situations, the auditor's preliminary judgment about materiality might be based on the entity's annualized interim financial statements or financial statements of one or more prior annual periods, as long as recognition is given to the effects of major changes in the entity's circumstances (for example, a significant merger) and relevant changes in the economy as a whole or the industry in which the entity operates. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

.22 Assuming, theoretically, that the auditor's judgment about materiality at the planning stage was based on the same information available at the evaluation stage, materiality for planning and evaluation purposes would be the same. However, it ordinarily is not feasible for the auditor, when planning an audit, to anticipate all of the circumstances that may ultimately influence judgments about materiality in evaluating the audit findings at the completion of the audit. Thus, the auditor's preliminary judgment about materiality ordinarily will differ from the judgment about materiality used in evaluating the audit findings. If significantly lower materiality levels become appropriate in evaluating audit findings, the auditor should re-evaluate the sufficiency of

STANDING ADVISORY GROUP MEETING

the auditing procedures he or she has performed. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

.23 In planning auditing procedures, the auditor should also consider the nature, cause (if known), and amount of misstatements that he or she is aware of from the audit of the prior period's financial statements. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

Considerations at the Individual Account-Balance or Class-of-Transactions Level

.24 The auditor recognizes that there is an inverse relationship between audit risk and materiality considerations. For example, the risk that a particular account balance or class of transactions and related assertions could be misstated by an extremely large amount might be very low, but the risk that it could be misstated by an extremely small amount might be very high. Holding other planning considerations equal, either a decrease in the level of audit risk that the auditor judges to be appropriate in an account balance or a class of transactions or a decrease in the amount of misstatements in the balance or class that the auditor believes could be material would require the auditor to do one or more of the following: (a) select a more effective auditing procedure, (b) perform auditing procedures closer to year end, or (c) increase the extent of a particular auditing procedure. [Paragraph renumbered and amended, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

.25 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. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

STANDING ADVISORY GROUP MEETING

.26 The auditor needs to consider audit risk at the individual account-balance or class-of-transactions level because such consideration directly assists in determining the scope of auditing procedures for the balance or class and related assertions. The auditor should seek to restrict audit risk at the individual balance or class level in such a way that will enable him or her, at the completion of the audit, to express an opinion on the financial statements taken as a whole at an appropriately low level of audit risk. Auditors use various approaches to accomplish that objective. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

.27 At the account-balance or class-of-transactions level, audit risk consists of (a) the risk (consisting of inherent risk and control risk) that the balance or class and related assertions contain misstatements (whether caused by error or fraud) that could be material to the financial statements when aggregated with misstatements in other balances or classes and (b) the risk (detection risk) that the auditor will not detect such misstatements. The discussion that follows describes audit risk in terms of three component risks. [fn 12](#) The way the auditor considers these component risks and combines them involves professional judgment and depends on the audit approach.

- a. *Inherent risk* is the susceptibility of an assertion to a material misstatement, assuming that there are no related controls. The risk of such misstatement is greater for some assertions and related balances or classes than for others. For example, complex calculations are more likely to be misstated than simple calculations. Cash is more susceptible to theft than an inventory of coal. Accounts consisting of amounts derived from accounting estimates pose greater risks than do accounts consisting of relatively routine, factual data. External factors also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement. In addition to those factors that are peculiar to a specific assertion for an account balance or a class of transactions, factors that relate to several or all of the balances or classes may influence the inherent risk related to an assertion for a specific balance or class. These latter factors include, for example, a lack of sufficient working capital to continue operations or a declining industry characterized by a large number of business failures.
- b. *Control risk* is the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the

STANDING ADVISORY GROUP MEETING

entity's internal control. That risk 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 control risk will always exist because of the inherent limitations of internal control.

- c. *Detection risk* is the risk that the auditor will not detect a material misstatement that exists in an assertion. Detection risk is a function of the effectiveness of an auditing procedure and of its application by the auditor. It arises partly from uncertainties that exist when the auditor does not examine 100 percent of an account balance or a class of transactions and partly because of other uncertainties that exist even if he or she were to examine 100 percent of the balance or class. Such other uncertainties arise because an auditor might select an inappropriate auditing procedure, misapply an appropriate procedure, or misinterpret the audit results. These other uncertainties can be reduced to a negligible level through adequate planning and supervision and conduct of a firm's audit practice in accordance with appropriate quality control standards.

[Paragraph renumbered and amended, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

.28 Inherent risk and control risk differ from detection risk in that they exist independently of the audit of financial statements, whereas detection risk relates to the auditor's procedures and can be changed at his or her discretion. Detection risk should bear an inverse relationship to inherent and control risk. The less the inherent and control risk the auditor believes exists, the greater the detection risk that can be accepted. Conversely, the greater the inherent and control risk the auditor believes exists, the less the detection risk that can be accepted. These components of audit risk may be assessed in quantitative terms such as percentages or in nonquantitative terms that range, for example, from a minimum to a maximum. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

.29 When the auditor assesses inherent risk for an assertion related to an account balance or a class of transactions, he or she evaluates numerous factors that involve professional judgment. In doing so, the auditor considers not only factors peculiar to the related assertion, but also, other factors pervasive to the financial statements taken as a

STANDING ADVISORY GROUP MEETING

whole that may also influence inherent risk related to the assertion. If an auditor concludes that the effort required to assess inherent risk for an assertion would exceed the potential reduction in the extent of auditing procedures derived from such an assessment, the auditor should assess inherent risk as being at the maximum when designing auditing procedures. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

.30 The auditor also uses professional judgment in assessing control risk for an assertion related to the account balance or class of transactions. The auditor's assessment of control risk is based on the sufficiency of evidential matter obtained to support the effectiveness of internal control in preventing or detecting misstatements in financial statement assertions. If the auditor believes controls are unlikely to pertain to an assertion or are unlikely to be effective, or believes that evaluating their effectiveness would be inefficient, he or she would assess control risk for that assertion at the maximum. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 147-149 of PCAOB Auditing Standard No. 2 regarding tests of controls.

.31 The auditor might make separate or combined assessments of inherent risk and control risk. If the auditor considers inherent risk or control risk, separately or in combination, to be less than the maximum, he or she should have an appropriate basis for these assessments. This basis may be obtained, for example, through the use of questionnaires, checklists, instructions, or similar generalized materials and, in the case of control risk, the understanding of internal control and the performance of suitable tests of controls. However, professional judgment is required in interpreting, adapting, or expanding such generalized material as appropriate in the circumstances. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

.32 The detection risk that the auditor can accept in the design of auditing procedures is based on the level to which he or she seeks to restrict audit risk related to the account balance or class of transactions and on the assessment of inherent and control risks. As the auditor's assessment of inherent risk and control risk decreases, the detection risk that can be accepted increases. It is not appropriate, however, for an auditor to rely completely on assessments of inherent risk and control risk to the

STANDING ADVISORY GROUP MEETING

exclusion of performing substantive tests of account balances and classes of transactions where misstatements could exist that might be material when aggregated with misstatements in other balances or classes. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

.33 An audit of financial statements is a cumulative process; as the auditor performs planned auditing procedures, the evidence obtained may cause him or her to modify the nature, timing, and extent of other planned procedures. As a result of performing auditing procedures or from other sources during the audit, information may come to the auditor's attention that differs significantly from the information on which the audit plan was based. For example, the extent of misstatements detected may alter the judgment about the levels of inherent and control risks, and other information obtained about the financial statements may alter the preliminary judgment about materiality. In such cases, the auditor may need to re-evaluate the auditing procedures he or she plans to apply, based on the revised consideration of audit risk and materiality for all or certain of the account balances or classes of transactions and related assertions. [Paragraph renumbered and amended, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

Evaluating Audit Findings

.34 In evaluating whether the financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, the auditor should consider the effects, both individually and in the aggregate, of misstatements that are not corrected by the entity. In evaluating the effects of misstatements, the auditor should include both qualitative and quantitative considerations (see paragraphs .08–.11). The consideration and aggregation of misstatements should include the auditor's best estimate of the total misstatements in the account balances or classes of transactions that he or she has examined (hereafter referred to as likely misstatements [fn 13](#)), not just the amount of misstatements specifically identified (hereafter referred to as known misstatements). [fn 14](#) Likely misstatements should be aggregated in a way that enables the auditor 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. Qualitative considerations also influence the auditor in reaching a conclusion as to whether misstatements are material. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997. As amended, effective September 2002, by Statement on Auditing Standards No. 98.]

STANDING ADVISORY GROUP MEETING

.35 When the auditor tests an account balance or a class of transactions and related assertions by an analytical procedure, he or she ordinarily would not specifically identify misstatements but would only obtain an indication of whether misstatement might exist in the balance or class and possibly its approximate magnitude. If the analytical procedure indicates that a misstatement might exist, but not its approximate amount, the auditor ordinarily would have to employ other procedures to enable him or her to estimate the likely misstatement in the balance or class. When an auditor uses audit sampling to test an assertion for an account balance or a class of transactions, he or she projects the amount of known misstatements identified in the sample to the items in the balance or class from which the sample was selected. That projected misstatement, along with the results of other substantive tests, contributes to the auditor's assessment of likely misstatement in the balance or class. [\[fn 15\]](#), [\[fn 16\]](#) [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997. As amended, effective September 2002, by Statement on Auditing Standards No. 98.]

.36 The risk of material misstatement of the financial statements is generally greater when account balances and classes of transactions include accounting estimates rather than essentially factual data because of the inherent subjectivity in estimating future events. Estimates, such as those for inventory obsolescence, uncollectible receivables, and warranty obligations, are subject not only to the unpredictability of future events but also to misstatements that may arise from using inadequate or inappropriate data or misapplying appropriate data. Since no one accounting estimate can be considered accurate with certainty, the auditor recognizes that a difference between an estimated amount best supported by the audit evidence and the estimated amount included in the financial statements may be reasonable, and such difference would not be considered to be a likely misstatement. However, if the auditor believes the estimated amount included in the financial statements is unreasonable, he or she should treat the difference between that estimate and the closest reasonable estimate as a likely misstatement. The auditor should also consider whether the difference between estimates best supported by the audit evidence and the estimates included in the financial statements, which are individually reasonable, indicate a possible bias on the part of the entity's management. For example, 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 audit evidence was to increase income, the auditor should reconsider the estimates taken as a whole. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997. As amended, effective September 2002, by Statement on Auditing Standards No. 98.]

STANDING ADVISORY GROUP MEETING

.37 In prior periods, likely misstatements may not have been corrected by the entity because they did not cause the financial statements for those periods to be materially misstated. Those misstatements might also affect the current period's financial statements. ^[fn.17] If the auditor believes that there is an unacceptably high risk that the current period's financial statements may be materially misstated when those prior-period likely misstatements that affect the current period's financial statements are considered along with likely misstatements arising in the current period, the auditor should include in aggregate likely misstatement the effect on the current period's financial statements of those prior-period likely misstatements. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

.38 If the auditor concludes, based on the accumulation of sufficient evidential matter, that the effects of likely misstatements, individually or in the aggregate, cause the financial statements to be materially misstated, the auditor should request management to eliminate the misstatement. If the material misstatement is not eliminated, the auditor should issue a qualified or an adverse opinion on the financial statements. Material misstatements may be eliminated by, for example, application of appropriate accounting principles, other adjustments in amounts, or the addition of appropriate disclosure of inadequately disclosed matters. Even though the effects of likely misstatements on the financial statements may be immaterial, the auditor should recognize that an accumulation of immaterial misstatements in the balance sheet could contribute to material misstatements of future financial statements. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997. As amended, effective September 2002, by Statement on Auditing Standards No. 98.]

.39 If the auditor concludes that the effects of likely misstatements, individually or in the aggregate, do not cause the financial statements to be materially misstated, he or she should recognize that they could still be materially misstated because of further misstatement remaining undetected. As the aggregate likely misstatements increase, the risk that the financial statements may be materially misstated also increases. The auditor generally reduces this risk of material misstatement in planning the audit by restricting the extent of detection risk he or she is willing to accept for an assertion related to an account balance or a class of transactions. The auditor can reduce this risk of material misstatement by modifying the nature, timing, and extent of planned auditing procedures in performing the audit. (See paragraph .33.) Nevertheless, if the auditor believes that such risk is unacceptably high, he or she should perform additional auditing procedures or satisfy himself or herself that the entity has adjusted the financial

STANDING ADVISORY GROUP MEETING

statements to reduce the risk of material misstatement to an acceptable level. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997. As amended, effective September 2002, by Statement on Auditing Standards No. 98.]

.40 The auditor should document the nature and effect of aggregated misstatements. The auditor also should document his or her conclusion as to whether the aggregated misstatements cause the financial statements to be materially misstated. [Paragraph added, effective for audits of financial statements for periods beginning on or after May 15, 2002, by Statement on Auditing Standards No. 96.]

.41 In aggregating likely misstatements that the entity has not corrected, pursuant to paragraphs .34 and .35, the auditor may designate an amount below which misstatements need not be accumulated. This amount should be set so that any such misstatements, either individually or when aggregated with other such misstatements, would not be material to the financial statements, after the possibility of further undetected misstatements is considered. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82. Paragraph renumbered by the issuance of Statement on Auditing Standards No. 96, January 2002. As amended, effective September 2002, by Statement on Auditing Standards No. 98.]

Effective Date

.42 This section is effective for audits of financial statements for periods beginning after June 30, 1984. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997. Paragraph subsequently renumbered by the issuance of Statement on Auditing Standards No. 96, January 2002.]

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Footnotes:

^{fn*} This section has been revised to reflect the conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53 through 62.

STANDING ADVISORY GROUP MEETING

[fn 1](#) See section 110, *Responsibilities and Functions of the Independent Auditor*, and section 230, *Due Professional Care in the Performance of Work*, for a further discussion of reasonable assurance. [As amended, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

[fn 2](#) In addition to audit risk, the auditor is also exposed to loss or injury to his or her professional practice from litigation, adverse publicity, or other events arising in connection with financial statements audited and reported on. This exposure is present even though the auditor has performed the audit in accordance with generally accepted auditing standards and has reported appropriately on those financial statements. Even if an auditor assesses this exposure as low, the auditor should not perform less extensive procedures than would otherwise be appropriate under generally accepted auditing standards.

[fn 3](#) This definition of audit risk does not include the risk that the auditor might erroneously conclude that the financial statements are materially misstated. In such a situation, the auditor would ordinarily reconsider or extend auditing procedures and request that the client perform specific tasks to re-evaluate the appropriateness of the financial statements. These steps would ordinarily lead the auditor to the correct conclusion. This definition also excludes the risk of an inappropriate reporting decision unrelated to the detection and evaluation of misstatements in the financial statements, such as an inappropriate decision regarding the form of the auditor's report because of a limitation on the scope of the audit. [As amended, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

[fn 4](#) The concepts of audit risk and materiality also are applicable to financial statements presented in conformity with a comprehensive basis of accounting other than generally accepted accounting principles; references in this section to financial statements presented in conformity with generally accepted accounting principles also include those presentations.

[fn 5](#) The auditor's consideration of illegal acts and responsibility for detecting misstatements resulting from illegal acts is defined in section 317, *Illegal Acts by Clients*. For those illegal acts that are defined in that section as having a direct and material effect on the determination of financial statement amounts, the auditor's

STANDING ADVISORY GROUP MEETING

responsibility to detect misstatements resulting from such illegal acts is the same as that for errors or fraud. [Footnote added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

[fn 6](#) Errors do not include the effect of accounting processes employed for convenience, such as maintaining accounting records on the cash basis or the tax basis and periodically adjusting those records to prepare financial statements in conformity with generally accepted accounting principles. [Footnote added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

[fn 7](#) See section 317. [Footnote renumbered and amended, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

[fn 8](#) [Footnote renumbered and deleted by the issuance of Statement on Auditing Standards No. 82, February 1997.]

[fn 9](#) This section amends section 311, *Planning and Supervision*, paragraph .03e, by substituting the words "Preliminary judgment about materiality levels" in place of the words "Preliminary estimates of materiality levels." [Footnote renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

[fn 10](#) See section 319, *Consideration of Internal Control in a Financial Statement Audit*. [Footnote added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

[fn 11](#) See section 316. [Footnote added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.]

[fn 12](#) The formula in the appendix [paragraph .48] to section 350, *Audit Sampling*, describes audit risk in terms of four component risks. Detection risk is presented in terms of two components: the risk that analytical procedures and other relevant substantive tests would fail to detect misstatements equal to tolerable misstatement, and the allowable risk of incorrect acceptance for the substantive test of details.

STANDING ADVISORY GROUP MEETING

[Footnote renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997.]

[fn 13](#) The term *likely misstatements* includes any known misstatements.

See section 316A.33–.35 for a further discussion of the auditor's consideration of differences between the accounting records and the underlying facts and circumstances. Those paragraphs provide specific guidance on the auditor's consideration of an audit adjustment that is, or may be, the result of fraud. [Footnote added, effective September 2002, by Statement on Auditing Standards No. 98.]

[fn 14](#) If the auditor were to examine all of the items in a balance or a class, the likely misstatement applicable to recorded transactions in the balance or class would be the amount of known misstatements specifically identified. [Footnote added, effective September 2002, by Statement on Auditing Standards No. 98.]

[fn 15](#) [Footnote renumbered and deleted by the issuance of Statement on Auditing Standards No. 98, September 2002.]

[fn 16](#) [Footnote renumbered and deleted by the issuance of Statement on Auditing Standards No. 98, September 2002.]

[fn 17](#) The measurement of the effect, if any, on the current period's financial statements of misstatements uncorrected in prior periods involves accounting considerations and is therefore not addressed in this section. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 82, February 1997. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 98, September 2002.]