

Chapter 8--Materiality, Risk and Preliminary Audit Strategies

Materiality

AU section 312 requires the auditor to consider materiality in (1) planning the audit and (2) assessing whether the financial statements, taken as a whole, are presented fairly in conformity with GAAP. The issue of materiality is closely linked to auditor liability. One of the critical issues for accountants in financial reporting is what must be disclosed, how much must be disclosed, who discloses it, and where that information is disclosed.

The materiality of a statement, misstatement, or omission is the basis for determining whether there is liability for auditors under the securities laws or fraud. However, the materiality concept remains an ambiguous concept. A myriad of research has shown that auditors do not reach a consensus as to the meaning of "material." SFAC #2 defines materiality as stated on p.225 in your textbook.

In narrow cases, FASB has issued specific guidelines on materiality (e.g., APB Opinion #15 requires fully diluted EPS to be disclosed if the reduction of per share earnings < 3%).

The auditor must consider the entity's circumstances and the information needs of users. What is material to one firm is not material to another firm.

There is one main difference between the auditor view of materiality and the judicial view of materiality. The judicial view is taken from a hindsight perspective with 20/20 vision. At the time of the audit, the auditor is forced to make decisions not knowing the outcome.

Planning Judgments About Materiality

Planning materiality--may differ from materiality levels at the end of the audit due to changes in circumstances. In audit planning, the auditor assesses materiality at:

Materiality at the Financial Statement Level

The minimum aggregate misstatement in a financial statement sufficient to prevent a statement from being presented in conformity with GAAP is materiality at the financial statement level. Sometimes there is more than one level of materiality relating to the financial statements (e.g., income statement Sales, Net Income).

Initially, the auditor ascertains the aggregate level of materiality for each statement. For audit planning purposes, the auditor uses the smallest aggregate level of misstatements considered to be material to any one of the financial statements.

Look at Figure 7-1 in your textbook for some quantitative guidelines.

Qualitative Considerations

Here we focus on causes of misstatements. One that is quantitatively immaterial may be qualitatively material (e.g., illegal act by client).

Materiality at the Account Balance Level

This refers to the minimum misstatement that can exist in an account balance to be deemed materially misstated. Materiality at the account balance level does not have the same meaning as material account balance (the latter refers to the size of a recorded account balance). An account with an immaterial balance may contain material understatements. The auditor should be planning the audit to take account of misstatements that become material when aggregated with other misstatements.

Allocating Financial Statement Materiality to Accounts

When allocating financial statement materiality to individual accounts, the auditor should take into account: 1) the likelihood of account misstatements; and 2) the cost of verifying the account. Please be sure you read the example on p.299 involving the Hart Co.

Relationships Between Materiality and Evidence

Materiality affects the auditor's judgment about the sufficiency of evidence. More evidence is normally required for accounts that are more likely to be misstated. Also, the lower the materiality level, the greater the amount of evidence needed. The more significant an account balance the greater the amount of evidence needed.

Audit Risk

Audit risk is the likelihood that an auditor will unknowingly fail to appropriately modify his or her opinion on materially misstated financial statements. Materiality must be established before risk has any meaning.

Desired audit risk--

Achieved audit risk--

It is not possible to quantify the audit risk achieved in an audit. The idea of a reasonable level of audit risk is subjective and determined by judgment. In some circumstances, very low audit risk is essential for both users and the auditor:

1--when users place heavy reliance on the financial statements

2--the likelihood a client will have financial difficulty

3--when the auditor has more legal liability exposure

Audit risk should be considered at the account balance level. Lower audit risk for the overall financial statements is achieved by obtaining a lower audit risk at the account balance level.

Audit Risk Model

$$AR = IR \times CR \times Dr$$

The three components that make up audit risk all relate to management assertions.

IR= Inherent Risk--the susceptibility of an assertion to a material misstatement assuming no internal control policies or procedures. The professional standards indicate that an auditor should consider factors affecting risk similar to those listed in AU section 316A--Auditor's Responsibility to Detect Errors and Irregularities (SAS 53 soon to be replaced by SAS 82). The risk factors you learned for SAS 82 are now paying you a dividend!

Inherent risk implies that auditors should attempt to predict where errors are most likely and least likely in the financial statement segments. The auditor should consider certain factors here:

1--dollar amount of account balances

2--population size

3--population makeup

4--nature of client's business

5--initial versus repeat engagement

- ◆ auditors who have prior knowledge about their clients can identify during the planning process those audit areas having the greatest

risk of error

6--results of current and previous audits

7--integrity of management

Inherent risk may be greater for some assertions than others.

The auditor cannot change the actual level of inherent risk. The auditor can change the assessed level of inherent risk. Inherent risk assessments occur mostly in the planning phase of the audit.

CR=Control Risk--the risk that a material misstatement that could occur in an assertion will not be prevented or detected by the entity's internal controls. Control risk cannot be zero.

The actual level of control risk for an assertion cannot be changed by the auditor. The auditor can change the assessed level of control risk through:

Auditors set a planned assessed level of control risk in audit planning. The planned assessed level is based on assumptions about the quality of the internal control structure. An actual assessed level of control risk is set for each assertion based on evidence about internal controls.

DR=Detection Risk--the likelihood that an auditor will not detect a material misstatement in an assertion. It is a function of the effectiveness of auditing procedures.

The auditor can change the actual level of detection risk by varying the nature, timing and extent of substantive tests.

The use of larger samples lowers detection risk. Why?

The performance of substantive tests at or near the balance sheet date also lowers detection risk. A planned level of detection risk is set using the audit risk model.

Relationships Among Risk Components

For a set level of audit risk, an inverse relationship exists between assessed levels of control and inherent risks and the level of detection risk. The auditor controls audit risk by adjusting detection risk based on the assessed levels of inherent and control risks.

Many auditors in practice do not quantify each risk component. Please familiarize yourself with the risk components matrix on p.236. The matrix assumes audit risk is restricted to a low level.

Assessed levels of inherent and control risk and acceptable level of detection risk can vary for each account and assertion. Assessments of levels of inherent, control and detection risk pertain to assertions at the account balance level.

Relationship Between Audit Risk and Audit Evidence

An inverse relationship exists between audit risk and the amount of evidence needed to support an auditor's opinion. Greater evidence for a lower level of audit risk. This inverse relationship also applies to detection risk. Inherent and control risks vary directly with the amount of evidence needed (e.g., low risk=low amount of evidence).

Preliminary Audit Strategies

The auditor sets four components:

- 1--planned assessed level of control risk
- 2--extent of understanding of internal controls
- 3--tests of controls
- 4--planned level of substantive tests

Preliminary audit strategies refer to an auditor's preliminary judgments about an

audit approach applied to assertions. A preliminary audit strategy may be based on certain assumptions.

The two extreme preliminary audit strategies are the primarily substantive approach and the lower assessed level of control risk approach. These approaches are used to specify the four components of an audit strategy.

Primarily Substantive Approach

This may be repetitive but here we go again with the four components of audit strategy:

1--maximum for planned assessed level of control risk

2--get a minimum understanding of internal controls

3--do few, if any, tests of controls

4--plan extensive substantive tests based on a low planned acceptable level of detection risk

by: This approach might be used for assertions involving accounts affected mainly

1--infrequent transactions (e.g., capital stock and bonds payable)

2--adjusting entries (e.g., accrued payables)

Lower Assessed Level of Control Risk Approach

Let's look at the four components of audit strategy here:

1--moderate or low level of planned assessed level of control risk

2--obtain an understanding of internal controls

3--extensive tests of controls

4--restricted substantive tests based on a moderate or high planned level of detection risk

This strategy is used when the client's internal controls are strong for an assertion.

Usually the auditor applies a strategy to groups of assertions affected by a transaction class within a transaction cycle. In this regard, please look at the cycles and classes of transactions on p. 243 in your textbook.

Overall Comments

SAS 82 has an impact on the use of the audit risk model. Audit risk related to the opinion on the overall financial statements encompasses the risk of material misstatements due to fraud as well as an error. Remember, SAS 82 requires the auditor to assess the risk of material misstatement of the financial statements due to fraud specifically. Also, certain fraud risk factors identified in SAS 82 may be described as inherent risks and others as control risks. The auditor's response to fraud risk factors may be reflected in determining acceptable levels of detection risk for assertions pertaining to specific transaction classes and accounts.

Many of the inherent risk factors on p. 232 could be classified according to the categories of fraud risk factors identified in SAS 82. Do not forget the list of fraud risk factors we outlined in class from Chapter 2.