

PROPOSED STATEMENT ON AUDITING STANDARDS
AUDIT RISK AND MATERIALITY IN CONDUCTING AN AUDIT
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PROPOSED STATEMENT ON AUDITING STANDARDS

AUDIT RISK AND MATERIALITY IN CONDUCTING AN AUDIT

1. This Statement provides guidance on the auditor's consideration of audit risk and materiality when 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 designing the nature, timing, and extent of audit procedures and in evaluating the results of those procedures.
2. 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."¹ Audit risk² is the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated.³
3. 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,⁴ while other matters are not important. In performing the audit, the auditor is concerned with matters that could be material to the financial statements. The auditor's responsibility is to plan and perform the audit to obtain reasonable assurance that material misstatements, whether caused by errors or fraud, are detected.

¹ See Statement on Auditing Standards (SAS) No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 110, "Responsibilities and Functions of the Independent Auditor," and AU sec. 230, "Due Professional Care in the Performance of Work"), as amended, for a further discussion of reasonable assurance.

² In addition to audit risk, the auditor is also exposed to loss of 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 does not perform less extensive audit procedures than otherwise is appropriate under generally accepted auditing standards.

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 ordinarily reconsiders or extends audit procedures and requests that management perform specific tasks to reevaluate the appropriateness of the financial statements. These steps 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 a misstatement 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.

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 as defined in SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623), as amended. References in this Statement to financial statements presented in conformity with generally accepted accounting principles also include those presentations.

Materiality in the Context of an Audit

4. The auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of users who will rely on the financial statements. The perceived needs of users 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.

Users

5. In an audit of financial statements, the auditor's judgment as to matters that are material to users of financial statements is based on consideration of the needs of users as a group; the auditor does not consider the possible effect of misstatements on specific individual users, whose needs may vary widely.⁵

6. The evaluation of whether a misstatement could influence economic decisions of users, and therefore be material, involves consideration of the characteristics of those users. Users are assumed to:

- a. Have an appropriate knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with an appropriate diligence;
- b. Understand that financial statements are prepared and audited to levels of materiality;
- c. Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment, and the consideration of future events; and
- d. Make appropriate economic decisions on the basis of the information in the financial statements.

The determination of materiality, therefore, takes into account how users with such characteristics could reasonably be expected to be influenced in making economic decisions.

Nature and Causes of Misstatements

7. 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. Misstatements can result from errors or fraud⁶ and may consist of any of the following:

⁵ When determining materiality in audits of financial statements or other historical financial information prepared for a special purpose, the auditor considers the needs of specific users in the context of the objective of the engagement.

⁶ The auditor's consideration of illegal acts and responsibility for detecting misstatements resulting from illegal acts is defined in SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317). For those illegal acts that are defined in that Statement as having a direct and material effect on the determination of financial statement

- a. An inaccuracy in gathering or processing data from which financial statements are prepared
- b. A difference between the amount, classification, or presentation of a reported financial statement element, account, or item and the amount, classification, or presentation that would have been reported under generally accepted accounting principles
- c. The omission of a financial statement element, account, or item
- d. A financial statement disclosure that is not presented in conformity with generally accepted accounting principles
- e. The omission of information required to be disclosed in conformity with generally accepted accounting principles⁷
- f. An incorrect accounting estimate arising, for example, from an oversight or misinterpretation of facts; and
- g. Differences between management's and the auditor's judgments concerning accounting estimates, or the selection and application of accounting policies that the auditor considers inappropriate.

8. The term *errors* refers to unintentional misstatements of amounts or disclosures in financial statements. The term *fraud* refers to an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage. Two types of misstatements resulting from fraud 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 Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316). 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.

9. Misstatements may be of two types: known and likely. Known misstatements consist of the amount of misstatements specifically identified. For example, the failure to accrue an unpaid invoice for goods received or services rendered prior to the end of the period presented would be a known misstatement. Likely misstatements represent the auditor's best estimate of the total misstatements in the account balances or classes of transactions that the auditor has examined.⁸

10. Although the auditor has no responsibility to plan and perform the audit to detect misstatements that are not material misstatements whether caused by error or fraud, there is a distinction in the auditor's response to detected misstatements. Generally, an error in processing accounting data or applying accounting principles that the auditor, upon evaluation, has determined to be immaterial is not significant to the audit. In contrast, when fraud is detected, regardless of its materiality, the auditor should consider the implications for the integrity of management or employees and the possible effect on other aspects of the audit.

amounts, the auditor's responsibility to detect misstatements resulting from such illegal acts is the same as that for errors or fraud.

⁷ Rule 203, *Accounting Principles* (AICPA, *Professional Standards*, vol. 2, ET sec. 203.01), provides for the possibility that literal application of pronouncements on accounting principles might, in unusual circumstances, result in misleading financial statements.

⁸ Likely misstatements in an account balance or class of transactions include any known misstatements in that balance or class.

Considerations at the Financial Statement Level

11. The auditor must consider audit risk and must determine a materiality level for the financial statements as a whole for the purpose of:
- a. Determining the extent and nature of risk assessment procedures
 - b. Identifying and assessing the risks of material misstatement
 - c. Determining the nature, timing, and extent of further audit procedures
 - d. Evaluating whether the financial statements as a whole are presented fairly, in conformity with generally accepted accounting principles
12. Audit risk is a function of the risk that the financial statements prepared by management are materially misstated and the risk that the auditor will not detect such material misstatement. The auditor should consider audit risk in relation to the individual account balances, classes of transactions, and disclosures and relevant assertions and at the overall financial statement level. The auditor should perform risk assessment procedures to assess the risks of material misstatement both at the financial statement and relevant assertion levels.⁹ The auditor may reduce audit risk by determining overall responses and designing the nature, timing, and extent of further audit procedures based on those assessments.¹⁰
13. The auditor should perform the audit to reduce audit risk to a low level that is, in the auditor's professional judgment, appropriate for expressing an opinion on the financial statements. Audit risk may be assessed in quantitative or nonquantitative terms.
14. The considerations of audit risk and materiality are affected by the size and complexity of the entity and the auditor's experience with the entity and knowledge of the entity and its environment, including its internal control. As discussed in paragraphs 17 through 26, certain entity-related factors also affect the nature, timing, and extent of audit procedures with respect to specific account balances, classes of transactions, and disclosures and relevant assertions.
15. In considering audit risk at the overall financial statement level, the auditor should consider risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many relevant assertions. Risks of this nature often relate to the entity's control environment and are not necessarily identifiable with specific relevant assertions at the class of transactions, account balance, or disclosure level. Such risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud, for example, through management override of internal control. In developing responses to the risks of material misstatement at the overall financial statement level, the auditor should consider such matters as the knowledge, skill, and ability of personnel assigned significant engagement responsibilities; whether certain aspects of the engagement need the involvement of a specialist; and the appropriate level of supervision of assistants.
16. In an audit of an entity with operations in multiple locations or with multiple components, the auditor should consider the extent to which audit 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

⁹ See the proposed SAS *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement (Assessing Risks)*, paragraph 103.

¹⁰ See the proposed SAS *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained (Performing Procedures)*.

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.

Considerations at the Individual Account Balance, Class of Transactions, or Disclosure Level

17. There is an inverse relationship between audit risk and materiality considerations. For example, the risk that a particular account balance, class of transactions, or disclosure and relevant 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 considerations equal, either a decrease in the level of audit risk that the auditor judges to be appropriate in an account balance, class of transactions, or disclosure or a decrease in the amount of misstatements in the balance, class, or disclosure that the auditor believes could be material would require the auditor to do one or more of the following: (a) perform more effective audit procedures, (b) perform audit procedures closer to year end, or (c) increase the extent of particular audit procedures.

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

19. The auditor should consider audit risk at the individual account balance, class of transactions, or disclosure level because such consideration directly assists in determining the nature, timing, and extent of further audit procedures for the balance, class, or disclosure and relevant assertions. For example, the auditor should consider the risk of understatement as well as overstatement at the relevant assertion level such as when a liability may be understated (completeness) or when inventory may be overstated as a result of obsolescence (valuation). The auditor should seek to reduce audit risk at the individual balance, class, or disclosure level in such a way that will enable the auditor, 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.

20. At the account balance, class of transactions, or disclosure level, audit risk (AR) consists of (a) the risk (consisting of inherent risk and control risk) that the balance, class, or disclosure and relevant assertions contain misstatements (whether caused by error or fraud) that could be material to the financial statements when aggregated with misstatements in other balances, classes, or disclosures and (b) the risk (detection risk) that the auditor will not detect such misstatements. These components of audit risk may be assessed in quantitative terms, such as percentages, or in nonquantitative terms such as *high*, *medium* or *low* risk. The way the auditor should consider these component risks and combines them involves professional judgment and depends on the auditor's approach or methodology.

21. The risk that the account balance, class of transactions, or disclosure and relevant assertions are misstated consists of the following two components:

- *Inherent risk* (IR) is the susceptibility of a relevant assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there are no related controls. The risk of such misstatement is greater for some assertions and related account balances, classes of transactions, and disclosures 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 that are subject to significant measurement uncertainty pose greater risks than do accounts consisting of relatively routine, factual data. External circumstances giving rise to business risks¹¹ 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 circumstances that are peculiar to a specific relevant assertion, factors in the entity and its environment that relate to several or all of the classes of transaction, account balances, or disclosures may influence the inherent risk related to a specific relevant assertion. 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.
- *Control risk* (CR) is the risk that a misstatement that could occur in a relevant assertion and that could be material, either individually or when aggregated with other misstatements, will not be prevented or detected on a timely basis by the 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.

22. Inherent risk and control risk are the entity's risks, that is, they exist independently of the audit of financial statements. This Statement and other SASs describe the risk of material misstatement (RMM) as the auditor's combined assessment of inherent risk and control risk; however, the auditor may make separate assessments of inherent risk and control risk. Furthermore, auditors may implement the concepts surrounding the assessment of inherent and control risks and responding to the risk of material misstatement in different ways as long as they achieve the same result.

23. The auditor should assess the risk of material misstatement at the relevant assertion level as a basis for further audit procedures. Although that assessment is a judgment rather than a precise measurement of risk, the auditor should have an appropriate basis for that assessment. This basis may be obtained through the risk assessment procedures performed to obtain an understanding of the entity and its environment, including its internal control, and through the performance of suitable tests of controls to obtain audit evidence about the operating effectiveness of controls, where appropriate.

24. *Detection risk* is the risk that the auditor will not detect a misstatement that exists in a relevant assertion that could be material, either individually or when aggregated with other misstatements. Detection risk is a function of the effectiveness of an audit procedure and of its application by the auditor. Detection risk cannot be reduced to zero because the auditor does not examine 100 percent of an account balance or a class of transactions and because of other factors. Such other factors include the possibility that an auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results. These other factors ordinarily are addressed through adequate planning, proper assignment of personnel to the engagement team, the application of professional skepticism, supervision and review of the audit work performed, and supervision and conduct of a firm's audit practice in accordance with appropriate quality control standards. Detection risk can be disaggregated into additional components of tests of details (TD) and substantive analytical procedures (AP).

¹¹ See paragraphs 31 through 35 of the proposed SAS *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.

25. Detection risk relates to the substantive audit procedures and is managed by the auditor's response to risk of material misstatement. For a given level of audit risk, detection risk should bear an inverse relationship to the risk of material misstatement at the relevant assertion level. The greater the risk of material misstatement, the less the detection risk that can be accepted by the auditor. Conversely, the lower risk of material misstatement, the greater the detection risk that can be accepted by the auditor. However, the auditor must perform substantive procedures on material account balances, classes of transactions, and disclosures.

26. The model, $AR = RMM \times TD \times AP$, expresses the general relationship of audit risk and the risks associated with the auditor's assessments of risk of material misstatement (inherent and control risks); of the risk that substantive tests of details and substantive analytical procedures would fail to detect a material misstatement that could occur in a relevant assertion, given that such misstatements occur and are not detected by the entity's controls; and of the allowable risk that material error will not be detected by the test of details, given that a material misstatement might occur in a relevant assertion and not be detected by internal control or substantive analytical procedures and other relevant substantive procedures. The model is not intended to be a mathematical formula including all factors that may influence the assessment of audit risk; however, some auditors find such a model to be useful when planning appropriate risk levels for audit procedures to reduce the auditor's desired audit risk to an appropriate level.¹²

Determining Materiality for the Financial Statements as a Whole When Planning the Audit

27. The auditor should determine a materiality level for the financial statements as a whole when establishing the overall audit strategy for the audit (see the proposed *SAS Planning and Supervision*). Determining a materiality level for the financial statements as a whole helps to guide the auditor's judgments in identifying and assessing the risks of material misstatements and in planning the nature, timing, and extent of further audit procedures. This materiality level does not, however, establish a threshold below which identified misstatements are always considered to be immaterial when evaluating those misstatements and their effect on the auditor's report. As discussed in paragraph 59, the circumstances related to some identified misstatements may cause the auditor to evaluate them as material even if they are below the materiality level determined when establishing the overall audit strategy.

28. The determination of what is material to the users is a matter of professional judgment. The auditor often applies a percentage to a chosen benchmark as a step in determining materiality for the financial statements as a whole. When identifying an appropriate benchmark, the auditor considers factors such as:

- The elements of the financial statements (for example, assets, liabilities, equity, income, and expenses) and the financial statement measures defined in generally accepted accounting principles (for example, financial position, financial performance, and cash flows), or other specific requirements.
- Whether there are financial statement items on which, for the particular entity, users' attention tends to be focused (for example, for the purpose of evaluating financial performance)
- The nature of the entity and the industry in which it operates; and
- The size of the entity, nature of its ownership and the way it is financed.

¹² Table 1 in the Appendix of the proposed *SAS Amendment to Statement on Auditing Standards No. 39, Audit Sampling*, illustrates how this application of the model might work when applying sampling.

Examples of benchmarks that might be appropriate, depending on the nature and circumstances of the entity, include total revenues, gross profit, and other categories of reported income, such as profit before tax from continuing operations. Profit before tax from continuing operations may be a suitable benchmark for profit-oriented entities but may not be an appropriate benchmark for the determination of materiality when, for example, the entity's earnings are volatile, when the entity is a not-for-profit entity, or when it is an owner-managed business where the owner takes much of the pretax income out of the business in the form of remuneration. For asset-based entities (for example, an investment fund) an appropriate benchmark might be net assets. Other entities (for example, banks, insurance companies) might use other benchmarks.

29. When determining materiality, the auditor should consider prior periods' financial results and financial positions, the period-to-date financial results and financial position, and budgets or forecasts for the current period, taking account of significant changes in the entity's circumstances (for example, a significant business acquisition) and relevant changes of conditions in the economy as a whole or the industry in which the entity operates. For example, when the auditor usually determines materiality for a particular entity based on a percentage of profit, circumstances that give rise to an exceptional decrease or increase in profit may lead the auditor to conclude that materiality is more appropriately determined using a normalized profit figure based on past results.

30. Once materiality is established, the auditor considers materiality when planning and evaluating the same way regardless of the inherent business characteristics of the entity being audited. Materiality is determined based on the auditor's understanding of the user needs and expectations. User expectations may differ based on the degree of inherent uncertainty associated with the measurement of particular items in the financial statements, among other considerations. For example, the fact that the financial statements include very large provisions with a high degree of estimation uncertainty (for example, provisions for insurance claims in the case of an insurance company, oil rig decommissioning costs in the case of an oil company, or, more generally, legal claims against an entity) may influence the user's assessment of materiality. However, for audit purposes, this factor does not cause the auditor to follow different procedures for planning or evaluating misstatements than those outlined for other entities.

Materiality for Particular Items of Lesser Amounts Than the Materiality Level Determined for the Financial Statements as a Whole

31. When establishing the overall strategy for the audit, the auditor should consider whether, in the specific circumstances of the entity, misstatements of particular items of lesser amounts than the materiality level determined for the financial statements as a whole, if any, could, in the auditor's judgment, reasonably be expected to influence economic decisions of users taken on the basis of the financial statements. Any such amounts determined represent lower materiality levels to be considered in relation to the particular items in the financial statements.

32. In making this judgment, the auditor should consider factors such as the following:

- Whether accounting standards, laws, or regulations affect users' expectations regarding the measurement or disclosure of certain items (for example, related party transactions and the remuneration of management and those charged with governance)
- The key disclosures in relation to the industry and the environment in which the entity operates (for example, research and development costs for a pharmaceutical company)
- Whether attention is focused on the financial performance of a particular business segment that is separately disclosed in the financial statements (for example, for a newly acquired business).

33. In considering whether, in the specific circumstances of the entity, misstatements of particular items of lesser amounts than the materiality level for the financial statements as a whole, if any, could reasonably be considered material by the users of the financial statements, the auditor may consider whether the views and expectations of those charged with governance and management might be helpful.

Tolerable Misstatement

34. *Tolerable misstatement* is the maximum error in a population (for example, the class of transactions or account balance) that the auditor is willing to accept. This term may be referred to as *tolerable error* in other standards.

35. The auditor should determine one or more levels of tolerable misstatement for classes of transactions, account balances, and disclosures.

36. When assessing the risks of material misstatements and designing and performing further audit procedures to respond to the assessed risks, the auditor should allow for the possibility that some misstatements of lesser amounts than the materiality levels determined in accordance with paragraphs 11 and 31 could, in the aggregate, result in a material misstatement of the financial statements. To do so, the auditor should determine one or more levels of tolerable misstatement. Such levels of tolerable misstatement are normally lower than the materiality levels.

37. The auditor must perform the audit to obtain reasonable assurance of detecting misstatements that the auditor 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 audit procedures to detect them.

Considerations as the Audit Progresses

38. In some situations, the auditor considers materiality for planning purposes before the financial statements to be audited are prepared. In those situations, the auditor's 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.

39. Because it is not feasible for the auditor to anticipate all the circumstances that may ultimately influence judgments about materiality in evaluating the audit findings at the completion of the audit, the auditor's judgment about materiality for planning purposes may differ from the judgment about materiality used in evaluating the audit findings.

40. If the auditor concludes that a lower materiality level than that initially determined is appropriate, the auditor should reconsider the related levels of tolerable misstatement and appropriateness of the nature, timing, and extent of audit procedures.

41. The auditor should consider whether the overall audit strategy and audit plan need to be revised if the nature of identified misstatements and the circumstances of their occurrence are indicative that other misstatements may exist that, when aggregated with identified misstatements, could be material. The auditor should not assume that a misstatement is an isolated occurrence.¹³

¹³ See paragraph 74 of the proposed SAS *Performing Procedures* for further guidance with respect to isolated misstatements.

42. If the aggregate of the misstatements (known and likely) that the auditor has identified approaches the materiality level, the auditor should consider whether there is a greater than acceptably low level of risk that undetected misstatements, when taken with the aggregate identified misstatements, could exceed the materiality level and, if so, the auditor should reconsider the nature and extent of further audit procedures.

Communication of Misstatements to Management

43. The auditor must accumulate all known and likely misstatements identified during the audit, other than those that the auditor believes are trivial,¹⁴ and communicate them to the appropriate level of management. This communication should occur on a timely basis.

44. Timely communication of potential misstatements to the appropriate level of management enables management to evaluate whether the items are misstatements, or to inform the auditor if they disagree, and to take action as necessary. The determination of which level of management is the appropriate one is based on such factors as the nature, size, and frequency of the misstatement and which level of management can take the necessary action.

45. When communicating details of misstatements the auditor should distinguish between:

- a. Known misstatements. These are specific misstatements arising from the incorrect selection or misapplication of accounting principles or misstatements of facts identified during the audit, including, for example, those arising from mistakes in gathering or processing data and the overlooking or misinterpretation of facts; and
- b. Likely misstatements. These are misstatements that:
 - i. Arise from differences between management's and the auditor's judgments concerning accounting estimates (for example, because an estimate included in the financial statements by management is outside of the reasonable range of outcomes the auditor has determined).
 - ii. The auditor considers likely to exist based on an extrapolation from audit evidence obtained, for example the amount obtained by projecting known misstatements identified in an audit sample to the entire population from which the sample was drawn.

46. The auditor should request management to correct all known misstatements, other than those that the auditor believes are trivial. Where the auditor evaluates the amount of likely misstatement in a class of transactions, account balance, or disclosure as material, either individually or in aggregate with other misstatements, the auditor should request management to examine the class of transactions, account balance, or disclosure in order to identify and correct misstatements therein. For example, if an auditor identifies a misstatement while testing the cost prices of raw materials inventory, the auditor extrapolates this misstatement to the raw materials account balance. If material, the auditor should then request management to examine the entire raw materials account balance to identify and correct any additional misstatements.

47. After management has examined a class of transactions, account balance, or disclosure and corrected misstatements that are found, the auditor should perform further audit procedures to reevaluate the amount of likely misstatement. The auditor should discuss with management the

¹⁴ Matters that are "trivial" are amounts designated by the auditor below which misstatements need not be accumulated. This amount is 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.

consequences for the auditor's report if management does not examine the class of transactions, account balance or disclosure to identify and correct misstatements found.

48. If management refuses to correct some or all of the misstatements communicated to it by the auditor, or identified when management examined a class of transactions, account balance, or disclosure, the auditor should obtain an understanding of management's reasons for not making the corrections and should take that into account when considering the qualitative aspects of the entity's accounting practices (see paragraph 59) and the implications for the auditor's report (see paragraph 66).

Evaluating Audit Findings¹⁵

49. In evaluating whether the financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, the auditor must consider the effects, both individually and in the aggregate, of misstatements (known and likely) that are not corrected by the entity. In making this evaluation, the auditor should consider the size and nature of the misstatements, both in relation to particular classes of transactions, account balances, and disclosures and the financial statements as a whole, and the particular circumstances of their occurrence.

50. The consideration and aggregation of misstatements should include likely misstatements (the auditor's best estimate of the total misstatements in the account balances or classes of transactions that he or she has examined),¹⁶ not just known misstatements (the amount of misstatements specifically identified).¹⁷ 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.

51. Before considering the aggregate effect of identified uncorrected misstatements, the auditor should consider each misstatement separately to evaluate:

a. Its effect in relation to the relevant individual classes of transactions, account balances, or disclosures, including whether materiality levels for particular items of lesser amounts than the materiality level for the financial statements as a whole, determined in accordance with paragraph 31, have been exceeded.

b. Whether, in considering the effect of the individual misstatement on the financial statements as a whole, it is appropriate to offset misstatements. For example, it may be inappropriate to offset misstatements of items that are disclosed separately in the financial statements.

c. The effect of misstatements related to prior periods. In prior periods, misstatements may not have been corrected by the entity because they did not cause the financial statements for

¹⁵ This consideration includes any misstatements that remain uncorrected from different entity locations or from audits of portions of the entity that are performed by other auditors.

¹⁶ See SAS No. 99 (AU sec. 316.68–.77) 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.

¹⁷ 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.

those periods to be materially misstated. Those misstatements might also affect the current period's financial statements.¹⁸

52. In aggregating misstatements, the auditor should include the effect on the current period's financial statements of those prior period misstatements. In doing this, the auditor should consider both the cumulative uncorrected misstatements that apply to the balance sheet, including misstatements arising in the current period, on the current period financial statements, and propose any necessary adjustments to reduce the amount of uncorrected misstatements to less than materiality.¹⁹ For example if a liability is understated as a result of misstatements that relate to prior and current periods, the auditor should consider the amount that would correct the liability, not just the amount that relates to the current period.²⁰ The auditor should also consider that more than one account may contain accumulated misstatements as a result of prior period uncorrected differences.

53. When the auditor tests an account balance or a class of transactions and relevant assertions by a substantive analytical procedure, the auditor ordinarily would not specifically identify misstatements but would obtain only an indication of whether misstatement might exist in the balance or class and possibly its approximate magnitude. If the substantive analytical procedure indicates that a misstatement might exist, but not its approximate amount, the auditor should request management to investigate and, if necessary, should expand his or her audit procedures to enable him or her to determine whether a misstatement exists in the account balance or class of transactions.

54. When an auditor uses audit sampling to test a relevant assertion for an account balance or a class of transactions, he or she should project 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 procedures, contributes to the auditor's assessment of likely misstatement in the balance or class.

55. The risk of material misstatement of the financial statements is generally greater when account balances and classes of transactions are subject to estimation rather than precise measurement 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. Because 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 not be significant, and such difference would not be considered to be a likely misstatement. However, if the auditor believes the estimated amount

¹⁸ 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.

¹⁹ The materiality used for this assessment should be relevant to the final financial statements, which may differ from planning materiality. Some entities base this assessment of materiality on income, and other entities (for example, not-for-profit or governmental entities) use other relevant bases of measurement. The auditor uses the same materiality base for these comparisons as he or she used in planning the engagement, updated to reflect period-end financial information.

²⁰ Some misstatements, such as inventory misstatements, may give rise to overstatements in one period and understatements in a later period. In this circumstance, the auditor considers the net effect (rollover effect) of the misstatements on current period income and also consider the period-end uncorrected misstatement in the inventory account when assessing whether an adjustment is required.

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.

56. The "closest reasonable estimate" may be a range of acceptable amounts or a precisely determined point estimate, if that is a better estimate than any other amount. In some cases, the auditor may use a method that produces a range of acceptable amounts to determine the reasonableness of amounts recorded. For example, the auditor's analysis of specific problem accounts receivable and recent trends in bad-debt write-offs as a percent of sales may cause the auditor to conclude that the allowance for doubtful accounts should be between \$130,000 and \$160,000. If management's recorded estimate²¹ falls within that range of acceptable amounts, the auditor ordinarily would conclude that the recorded amount is reasonable and no difference would be aggregated. If management's recorded estimate falls outside the auditor's range of acceptable amounts, the difference between the recorded amount and the amount at the closest end of the auditor's range would be aggregated as a likely misstatement.²²

57. 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.²³ In these circumstances, the auditor should reconsider whether other recorded estimates reflect a similar bias and should perform additional audit procedures that address those estimates. In addition, the auditor should be alert to the possibility that management's recorded estimates were clustered at one end of the range of acceptable amounts in the preceding year and clustered at the other end of the range of acceptable amounts in the current year, thus indicating the possibility that management is using swings in accounting estimates to offset higher- or lower-than-expected earnings. If the auditor believes that such circumstances exist, he or she should consider whether these matters should be communicated to those charged with governance, as described in SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380.08 and 380.11), as amended.

58. As discussed in paragraph 4, there are quantitative and qualitative materiality considerations. 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.²⁴

59. Qualitative considerations also influence the auditor in reaching a conclusion about whether misstatements are material. Qualitative factors that the auditor may consider relevant to his or her consideration of whether misstatements are material include the following:

²¹ SAS No. 101, *Auditing Fair Value Measurement and Disclosures* (AICPA, *Professional Standards*, vol. 1, AU sec. 328), and SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), provide guidance with respect the auditor's procedures to obtain an understanding of management estimation process.

²² See Interpretation No. 14, "Reasonable Estimation of the Amount of a Loss," of FASB Statement No. 5, *Accounting for Contingencies*.

²³ SAS No. 99 (AU sec. 316.64) also provides guidance to the auditor in performing a retrospective review of significant accounting estimates reflected in the financial statements of the prior year to determine whether management judgments and assumptions relating to the estimates indicate a possible bias on the part of management.

²⁴ See SAS No. 54.

- a. The potential effect of the misstatement on trends, especially trends in profitability.
- b. A misstatement that changes a loss into income or vice versa.
- c. The potential effect of the misstatement on the entity's compliance with loan covenants, other contractual agreements, and regulatory provisions.
- d. The existence of statutory or regulatory reporting requirements that affect materiality thresholds.
- e. Masks a change in earnings or other trends, especially in the context of general economic and industry conditions.
- f. A misstatement that has the effect of increasing management's compensation, for example, by satisfying the requirements for the award of bonuses or other forms of incentive compensation.
- g. The sensitivity of the circumstances surrounding the misstatement, for example, the implications of misstatements involving fraud and possible illegal acts, violations of contractual provisions, and conflicts of interest.
- h. The significance of the financial statement element affected by the misstatement, for example, a misstatement affecting recurring earnings as contrasted to one involving a nonrecurring charge or credit, such as an extraordinary item.
- i. The effects of misclassifications, for example, misclassification between operating and nonoperating income or recurring and nonrecurring income items or a misclassification between fundraising costs and program activity costs in a not-for-profit organization.
- j. The significance of the misstatement relative to reasonable user needs, for example:
 - Earnings to investors and the equity amounts to creditors.
 - The magnifying effects of a misstatement on the calculation of purchase price in a transfer of interests (buy-sell agreement).
 - The effect of misstatements of earnings when contrasted with expectations.

Obtaining the views and expectations of those charged with governance and management may be helpful in gaining or corroborating an understanding of user needs, such as those illustrated above.

- k. The definitive character of the misstatement, for example, the precision of an error that is objectively determinable as contrasted with a misstatement that unavoidably involves a degree of subjectivity through estimation, allocation, or uncertainty.
- l. The motivation of management with respect to the misstatement, for example, (1) an indication of a possible pattern of bias by management when developing and accumulating accounting estimates, (2) a misstatement precipitated by management's continued unwillingness to correct weaknesses in the financial reporting process, or (3) intentional decision not to follow generally accepted accounting principles.
- m. The existence of offsetting effects of individually significant but different misstatements.

n. The likelihood that a misstatement that is currently immaterial may have a material effect in future periods because of a cumulative effect, for example, that builds over several periods.

o. The cost of making the correction. It may not be cost-beneficial for the client to develop a system to calculate a basis to record the effect of an immaterial misstatement. On the other hand, if management appears to have developed a system to calculate an amount that represents an immaterial misstatement, it may reflect a motivation of management as noted in item *l* above.

p. The risk that possible additional undetected misstatements would affect the auditor's evaluation.

These circumstances are only examples; not all are likely to be present in all audits, nor is the list necessarily complete. The existence of any circumstances such as these does not necessarily lead to a conclusion that the misstatement is material.

60. If the auditor believes that a misstatement is, or may be, the result of fraud, the auditor should consider the implications of the misstatement in relation to other aspects of the audit as described in SAS No. 99, even if the effect of the misstatement is not material to the financial statements.

Evaluating Whether the Financial Statements as a Whole Are Free of Material Misstatement

61. The auditor must evaluate whether the financial statements as a whole are free of material misstatement. In making this evaluation, the auditor should consider both the evaluation of the uncorrected (known and likely) misstatements required in paragraph 49 and the qualitative considerations in paragraph 59.

62. When concluding as to whether the effect of misstatements, individually or in the aggregate, is material, an auditor should consider the nature and amount of the misstatements 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.

63. If the auditor believes that the financial statements as a whole are materially misstated, the auditor should request management to make the necessary corrections. If management refuses to make the corrections, the auditor must determine the implications for the auditor's report (see paragraph 66).

64. If the auditor concludes that the effects of uncorrected misstatements, individually or in the aggregate, do not cause the financial statements to be materially misstated, they could still be materially misstated because of further misstatement remaining undetected. As the aggregate misstatements approach materiality, the risk that the financial statements may be materially misstated also increases; consequently, the auditor should also consider the effect of undetected misstatements in concluding whether the financial statements are fairly stated.

65. The auditor can reduce audit risk by modifying the nature, timing, and extent of planned audit procedures in performing the audit. If the auditor believes that such risk is unacceptably high, the auditor should perform additional audit procedures or satisfy himself or herself that the

entity has adjusted the financial statements to reduce the risk of material misstatement to an appropriate level.²⁵

Evaluating the Overall Effect of Audit Findings on the Auditor's Report

66. If the auditor concludes that, or is unable to conclude whether, the financial statements are materially misstated, the auditor must determine the implications for the auditor's report on the financial statements.

Communications With Those Charged With Governance

67. Standards and guidance regarding communications about materiality and misstatements to those charged with governance are set out in SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380).

Documentation

68. The auditor should document:

- a. The levels of materiality, as discussed in paragraph 27, and tolerable misstatement, including any changes thereto, used in the audit and the basis on which those levels were determined;
- b. A summary of uncorrected misstatements, other than those that are trivial, related to known and likely misstatements; and
- c. The auditor's conclusion as to whether uncorrected misstatements, individually or in aggregate, do or do not cause the financial statements to be materially misstated, and the basis for that conclusion.

69. Uncorrected misstatements should be documented in a manner that allows the auditor to:

- a. Separately consider the effects of known and likely misstatements;
- b. Consider the aggregate effect of misstatements on the financial statements; and
- c. Consider the qualitative factors that are relevant to the auditor's consideration whether misstatements are material (see paragraph 61).

Effective Date

70. This Statement is effective for audits of financial statements for periods beginning on or after December 15, 2006. Earlier application is permitted.

²⁵ See paragraphs 71 through 77 of the proposed SAS *Performance Procedures*, with respect to the auditor's evaluation of the sufficiency and appropriateness of audit evidence obtained.