1997

# Consideration of fraud in a financial statement audit; Statement on auditing standards, 082

American Institute of Certified Public Accountants. Auditing Standards Executive Committee

February 1997

# 82

# Statement on Auditing Standards

Issued by the Auditing Standards Board

AICPA

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

# Consideration of Fraud in a Financial Statement Audit

*(Supersedes Statement on Auditing Standards No. 53, AICPA,* Professional Standards, *vol. 1, AU sec. 316; and amends AU sec. 110, "Responsibilities and Functions of the Independent Auditor" and AU sec. 230, "Due Care in the Performance of Work" of Statement on Auditing Standards No. 1, AICPA,* Professional Standards, *vol. 1, and Statement on Auditing Standards No. 47, AICPA,* Professional Standards, *vol. 1, AU sec. 312.)*

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# SAS No. 82
# Consideration of Fraud in a Financial Statement Audit*

***(Supersedes Statement on Auditing Standards No. 53, AICPA,* Professional Standards, *vol. 1, AU sec. 316; and amends AU sec. 110, "Responsibilities and Functions of the Independent Auditor" and AU sec. 230, "Due Care in the Performance of Work" of Statement on Auditing Standards No. 1, AICPA,* Professional Standards, *vol. 1, and Statement on Auditing Standards No. 47, AICPA,* Professional Standards, *vol. 1, AU sec. 312.)***

## Introduction

1. AU Section 110 of Statement on Auditing Standards (SAS) No. 1, *Codification of Auditing Standards and Procedures,* as amended by this Statement [appendix A] (AICPA, *Professional Standards,* vol. 1, AU sec. 110, "Responsibilities and Functions of the Independent Auditor"), states that "The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud."[1] This Statement provides guidance to auditors in fulfilling that responsibility, as it relates to fraud, in an audit of financial statements conducted in accordance with generally accepted auditing standards. Specifically, this Statement—

- Describes fraud and its characteristics (see paragraphs 3 through 10).
- Requires the auditor to specifically assess the risk of material misstatement due to fraud and provides categories of fraud risk factors to be considered in the auditor's assessment (see paragraphs 11 through 25).

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*All references to AU section 110 of SAS No. 1, AU section 230 of SAS No. 1, or to SAS No. 47 "as amended by this Statement" reflect the amendments that appear in appendixes A, B, and C, respectively, in this Statement.

[1] 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 amounts, the auditor's responsibility to detect misstatements resulting from such illegal acts is the same as that for errors (see SAS No. 47, *Audit Risk and Materiality in Conducting an Audit,* as amended by this Statement [appendix C] [AICPA, *Professional Standards,* vol. 1, AU sec. 312]) or fraud.

- Provides guidance on how the auditor responds to the results of the assessment (see paragraphs 26 through 32).
- Provides guidance on the evaluation of audit test results as they relate to the risk of material misstatement due to fraud (see paragraphs 33 through 36).
- Describes related documentation requirements (see paragraph 37).
- Provides guidance regarding the auditor's communication about fraud to management, the audit committee, and others (see paragraphs 38 through 40).

2. While this Statement focuses on the auditor's consideration of fraud in an audit of financial statements, management is responsible for the prevention and detection of fraud.[2] That responsibility is described in paragraph 3 of SAS No. 1, AU section 110, "Responsibilities and Functions of the Independent Auditor," as amended, which states, "Management is responsible for adopting sound accounting policies and for establishing and maintaining internal control that will, among other things, record, process, summarize, and report transactions consistent with management's assertions embodied in the financial statements."

## Description and Characteristics of Fraud

3. Although fraud is a broad legal concept, the auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. 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.[3] Two types of misstatements are relevant to the auditor's consideration of fraud in a

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[2] In its October 1987 report, the National Commission on Fraudulent Financial Reporting, also known as the Treadway Commission, noted that "The responsibility for reliable financial reporting resides first and foremost at the corporate level. Top management—starting with the chief executive officer—sets the tone and establishes the financial reporting environment. Therefore, reducing the risk of fraudulent financial reporting must start with the reporting company."

[3] Intent is often difficult to determine, particularly in matters involving accounting estimates and the application of accounting principles. For example, unreasonable accounting estimates may be unintentional or may be the result of an intentional attempt to misstate the financial statements. Although the auditor has no responsibility to determine intent, the auditor's responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement is relevant in either case.

financial statement audit—misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets.[4] These two types of misstatements are described in the following paragraphs.

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

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

5. *Misstatements arising from misappropriation of assets* (sometimes referred to as defalcation) involve the theft of an entity's assets where the effect of the theft causes the financial statements not to be presented in conformity with generally accepted accounting principles.[5] Misappropriation can be accomplished in various ways, including embezzling receipts, stealing assets, or causing an entity to pay for goods or services not received. Misappropriation of assets may be accompanied by false or misleading records or documents and may involve one or more individuals among management, employees, or third parties.

6. Fraud frequently involves the following: (*a*) a pressure or an incentive to commit fraud and (*b*) a perceived opportunity to do so. Although specific pressures and opportunities for fraudulent financial reporting may differ from those for misappropriation of assets, these two conditions usually are present for both types of fraud. For example, fraudulent financial reporting may be committed because management is under pressure to achieve an unrealistic earnings target.

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[4] Unauthorized transactions also are relevant to the auditor when they could cause a misstatement in financial statements. When such transactions are intentional and result in material misstatement of the financial statements, they would fall into one of the two types of fraud discussed in this Statement. Also see the guidance in SAS No. 54.

[5] Reference to generally accepted accounting principles includes, where applicable, 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), paragraph 4.

Misappropriation of assets may be committed because the individuals involved are living beyond their means. A perceived opportunity may exist in either situation because an individual believes he or she could circumvent internal control.

7. Fraud may be concealed through falsified documentation, including forgery. For example, management that engages in fraudulent financial reporting might attempt to conceal misstatements by creating fictitious invoices, while employees or management who misappropriate cash might try to conceal their thefts by forging signatures or creating invalid electronic approvals on disbursement authorizations. An audit conducted in accordance with generally accepted auditing standards rarely involves authentication of documentation, nor are auditors trained as or expected to be experts in such authentication.

8. Fraud also may be concealed through collusion among management, employees, or third parties. For example, through collusion, false evidence that control activities have been performed effectively may be presented to the auditor. As another example, the auditor may receive a false confirmation from a third party who is in collusion with management. Collusion may cause the auditor to believe that evidence is persuasive when it is, in fact, false.

9. Although fraud usually is concealed, the presence of risk factors or other conditions may alert the auditor to a possibility that fraud may exist. For example, a document may be missing, a general ledger may be out of balance, or an analytical relationship may not make sense. However, these conditions may be the result of circumstances other than fraud. Documents may have been legitimately lost; the general ledger may be out of balance because of an unintentional accounting error; and unexpected analytical relationships may be the result of unrecognized changes in underlying economic factors. Even reports of alleged fraud may not always be reliable, because an employee or outsider may be mistaken or may be motivated to make a false allegation.

10. An auditor cannot obtain absolute assurance that material misstatements in the financial statements will be detected. Because of (*a*) the concealment aspects of fraudulent activity, including the fact that fraud often involves collusion or falsified documentation, and (*b*) the need to apply professional judgment in the identification and evaluation of fraud risk factors and other conditions, even a properly planned and performed audit may not detect a material misstatement resulting from fraud. Accordingly, because of the above characteristics of fraud and the

nature of audit evidence as discussed in AU section 230 of SAS No. 1, as amended by this Statement [appendix B] (AICPA, *Professional Standards,* vol. 1, AU sec. 230, "Due Professional Care in the Performance of Work"), the auditor is able to obtain only reasonable assurance that material misstatements in the financial statements, including misstatements resulting from fraud, are detected.

## Assessment of the Risk of Material Misstatement Due to Fraud

11. SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards,* vol. 1, AU sec. 311), provides guidance as to the level of knowledge of the entity's business that will enable the auditor to plan and perform an audit of financial statements in accordance with generally accepted auditing standards. SAS No. 47, *Audit Risk and Materiality in Conducting an Audit,* as amended by this Statement (AICPA, *Professional Standards,* vol. 1, AU sec. 312), provides that determination of the scope of the auditing procedures is directly related to the consideration of audit risk and indicates that the risk of material misstatement of the financial statements due to fraud is part of audit risk.

12. The auditor should specifically assess the risk of material misstatement of the financial statements due to fraud and should consider that assessment in designing the audit procedures to be performed. In making this assessment, the auditor should consider fraud risk factors that relate to both (*a*) misstatements arising from fraudulent financial reporting and (*b*) misstatements arising from misappropriation of assets in each of the related categories presented in paragraphs 16 and 18.[6] While such risk factors do not necessarily indicate the existence of fraud,

[6] The auditor should assess the risk of material misstatement due to fraud regardless of whether the auditor otherwise plans to assess inherent or control risk at the maximum (see paragraphs 29 and 30 of SAS No. 47, as amended by this Statement). An auditor may meet this requirement using different categories of risk factors as long as the assessment embodies the substance of each of the risk categories described in paragraphs 16 and 18. Also, since these risk categories encompass both inherent and control risk attributes, the specific assessment of the risk of material misstatement due to fraud may be performed in conjunction with the assessment of audit risk required by SAS No. 47, paragraphs 13 through 33, as amended by this Statement, and SAS

(*continued*)

they often have been observed in circumstances where frauds have occurred.

13. As part of the risk assessment, the auditor also should inquire of management (*a*) to obtain management's understanding regarding the risk of fraud in the entity and (*b*) to determine whether they have knowledge of fraud that has been perpetrated on or within the entity. Information from these inquiries could identify fraud risk factors that may affect the auditor's assessment and related response. Some examples of matters that might be discussed as part of the inquiry are (*a*) whether there are particular subsidiary locations, business segments, types of transactions, account balances, or financial statement categories where fraud risk factors exist or may be more likely to exist and (*b*) how management may be addressing such risks.

14. Although the fraud risk factors described in paragraphs 17 and 19 below cover a broad range of situations typically faced by auditors, they are only examples. Moreover, not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size, with different ownership characteristics, in different industries, or because of other differing characteristics or circumstances. Accordingly, the auditor should use professional judgment when assessing the significance and relevance of fraud risk factors and determining the appropriate audit response.

15. For example, in a small entity domination of management by a single individual generally does not, in and of itself, indicate a failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. As another example, there may be little motivation for fraudulent financial reporting by management of a privately held business when the financial statements audited are used only in connection with seasonal bank borrowings, debt covenants are not especially burdensome, and the entity has a long history of financial success consistent with the industry in which it operates. Conversely, management of a small entity with unusually rapid growth or profitability may be motivated to avoid an interruption in its growth trends, especially compared with others in its industry.

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No. 55, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), paragraphs 27 through 38. Furthermore, the assessment of audit risk may identify the presence of additional fraud risk factors that the auditor should consider.

## Risk Factors Relating to Misstatements Arising From Fraudulent Financial Reporting

16. Risk factors that relate to misstatements arising from fraudulent financial reporting may be grouped in the following three categories:

a. *Management's characteristics and influence over the control environment.* These pertain to management's abilities, pressures, style, and attitude relating to internal control and the financial reporting process.
b. *Industry conditions.* These involve the economic and regulatory environment in which the entity operates.
c. *Operating characteristics and financial stability.* These pertain to the nature and complexity of the entity and its transactions, the entity's financial condition, and its profitability.

17. The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting for each of the three categories described above:

a. *Risk factors relating to management's characteristics and influence over the control environment.* Examples include —
   - A motivation for management to engage in fraudulent financial reporting. Specific indicators might include —
     - — A significant portion of management's compensation represented by bonuses, stock options, or other incentives, the value of which is contingent upon the entity achieving unduly aggressive targets for operating results, financial position, or cash flow.
     - — An excessive interest by management in maintaining or increasing the entity's stock price or earnings trend through the use of unusually aggressive accounting practices.
     - — A practice by management of committing to analysts, creditors, and other third parties to achieve what appear to be unduly aggressive or clearly unrealistic forecasts.
     - — An interest by management in pursuing inappropriate means to minimize reported earnings for tax-motivated reasons.
   - A failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. Specific indicators might include —
     - — An ineffective means of communicating and supporting the

entity's values or ethics, or communication of inappropriate values or ethics.

- — Domination of management by a single person or small group without compensating controls such as effective oversight by the board of directors or audit committee.
- — Inadequate monitoring of significant controls.
- — Management failing to correct known reportable conditions on a timely basis.
- — Management setting unduly aggressive financial targets and expectations for operating personnel.
- — Management displaying a significant disregard for regulatory authorities.
- — Management continuing to employ an ineffective accounting, information technology, or internal auditing staff.

- Nonfinancial management's excessive participation in, or preoccupation with, the selection of accounting principles or the determination of significant estimates.
- High turnover of senior management, counsel, or board members.
- Strained relationship between management and the current or predecessor auditor. Specific indicators might include —
  - — Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters.
  - — Unreasonable demands on the auditor including unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's reports.
  - — Formal or informal restrictions on the auditor that inappropriately limit his or her access to people or information or his or her ability to communicate effectively with the board of directors or the audit committee.
  - — Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work.
- Known history of securities law violations or claims against the entity or its senior management alleging fraud or violations of securities laws.

*b. Risk factors relating to industry conditions.* Examples include —

- New accounting, statutory, or regulatory requirements that could impair the financial stability or profitability of the entity.
- High degree of competition or market saturation, accompanied by declining margins.
- Declining industry with increasing business failures and significant declines in customer demand.
- Rapid changes in the industry, such as high vulnerability to rapidly changing technology or rapid product obsolescence.

c. *Risk factors relating to operating characteristics and financial stability.* Examples include —
   - Inability to generate cash flows from operations while reporting earnings and earnings growth.
   - Significant pressure to obtain additional capital necessary to stay competitive considering the financial position of the entity—including need for funds to finance major research and development or capital expenditures.
   - Assets, liabilities, revenues, or expenses based on significant estimates that involve unusually subjective judgments or uncertainties, or that are subject to potential significant change in the near term in a manner that may have a financially disruptive effect on the entity — such as ultimate collectibility of receivables, timing of revenue recognition, realizability of financial instruments based on the highly subjective valuation of collateral or difficult-to-assess repayment sources, or significant deferral of costs.
   - Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.
   - Significant, unusual, or highly complex transactions, especially those close to year end, that pose difficult "substance over form" questions.
   - Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.
   - Overly complex organizational structure involving numerous or unusual legal entities, managerial lines of authority, or contractual arrangements without apparent business purpose.
   - Difficulty in determining the organization or individual(s) that control(s) the entity.

- Unusually rapid growth or profitability, especially compared with that of other companies in the same industry.
- Especially high vulnerability to changes in interest rates.
- Unusually high dependence on debt or marginal ability to meet debt repayment requirements; debt covenants that are difficult to maintain.
- Unrealistically aggressive sales or profitability incentive programs.
- Threat of imminent bankruptcy or foreclosure, or hostile takeover.
- Adverse consequences on significant pending transactions, such as a business combination or contract award, if poor financial results are reported.
- Poor or deteriorating financial position when management has personally guaranteed significant debts of the entity.

## Risk Factors Relating to Misstatements Arising From Misappropriation of Assets

18. Risk factors that relate to misstatements arising from misappropriation of assets may be grouped in the two categories below. The extent of the auditor's consideration of the risk factors in category *b* is influenced by the degree to which risk factors in category *a* are present.

*a.* *Susceptibility of assets to misappropriation.* These pertain to the nature of an entity's assets and the degree to which they are subject to theft.

*b.* *Controls.* These involve the lack of controls designed to prevent or detect misappropriations of assets.

19. The following are examples of risk factors relating to misstatements arising from misappropriation of assets for each of the two categories described above:

*a.* *Risk factors relating to susceptibility of assets to misappropriation*

- Large amounts of cash on hand or processed
- Inventory characteristics, such as small size, high value, or high demand
- Easily convertible assets, such as bearer bonds, diamonds, or computer chips

- Fixed asset characteristics, such as small size, marketability, or lack of ownership identification

*b. Risk factors relating to controls*

- Lack of appropriate management oversight (for example, inadequate supervision or monitoring of remote locations)
- Lack of job applicant screening procedures relating to employees with access to assets susceptible to misappropriation
- Inadequate recordkeeping with respect to assets susceptible to misappropriation
- Lack of appropriate segregation of duties or independent checks
- Lack of appropriate system of authorization and approval of transactions (for example, in purchasing)
- Poor physical safeguards over cash, investments, inventory, or fixed assets
- Lack of timely and appropriate documentation for transactions (for example, credits for merchandise returns)
- Lack of mandatory vacations for employees performing key control functions

20. The auditor is not required to plan the audit to discover information that is indicative of financial stress of employees or adverse relationships between the entity and its employees. Nevertheless, the auditor may become aware of such information. Some examples of such information include (*a*) anticipated future employee layoffs that are known to the workforce, (*b*) employees with access to assets susceptible to misappropriation who are known to be dissatisfied, (*c*) known unusual changes in behavior or lifestyle of employees with access to assets susceptible to misappropriation, and (*d*) known personal financial pressures affecting employees with access to assets susceptible to misappropriation. If the auditor becomes aware of the existence of such information, he or she should consider it in assessing the risk of material misstatement arising from misappropriation of assets.

## Consideration of Risk Factors in Assessing the Risk of Material Misstatement Due to Fraud

21. Fraud risk factors cannot easily be ranked in order of importance or combined into effective predictive models. The significance of risk factors varies widely. Some of these factors will be present in entities

where the specific conditions do not present a risk of material misstatement. Accordingly, the auditor should exercise professional judgment when considering risk factors individually or in combination and whether there are specific controls that mitigate the risk. For example, an entity may not screen newly hired employees having access to assets susceptible to theft. This factor, by itself, might not significantly affect the assessment of the risk of material misstatement due to fraud. However, if it were coupled with a lack of appropriate management oversight and a lack of physical safeguards over such assets as readily marketable inventory or fixed assets, the combined effect of these related factors might be significant to that assessment.

22. The size, complexity, and ownership characteristics of the entity have a significant influence on the consideration of relevant risk factors. For example, in the case of a large entity, the auditor ordinarily would consider factors that generally constrain improper conduct by senior management, such as the effectiveness of the board of directors, the audit committee or others with equivalent authority and responsibility, and the internal audit function. The auditor also would consider what steps had been taken to enforce a formal code of conduct and the effectiveness of the budgeting or reporting system. Furthermore, risk factors evaluated at a country-specific or business segment operating level may provide different insights than the evaluation at an entity-wide level.[7] In the case of a small entity, some or all of these considerations might be inapplicable or less important. For example, a smaller entity might not have a written code of conduct but, instead, develop a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example.

23. SAS No. 55, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), requires the auditor to obtain a sufficient understanding of the entity's internal control over financial reporting to plan the audit. It also notes that such knowledge should be used to identify types of potential misstatements, consider factors that affect the risk of material misstatement, and design substantive tests. The understanding often will affect the auditor's consideration of the significance of fraud risk factors. In addition, when considering the

[7] SAS No. 47, paragraph 18, as amended by this Statement, provides guidance on the auditor's consideration of the extent to which auditing procedures should be performed at selected locations or components.

significance of fraud risk factors, the auditor may wish to assess whether there are specific controls that mitigate the risk or whether specific control deficiencies may exacerbate the risk.[8]

24. If the entity has established a program that includes steps to prevent, deter, and detect fraud, the auditor may consider its effectiveness. The auditor also should inquire of those persons overseeing such programs as to whether the program has identified any fraud risk factors.

25. The assessment of the risk of material misstatement due to fraud is a cumulative process that includes a consideration of risk factors individually and in combination. In addition, fraud risk factors may be identified while performing procedures relating to acceptance or continuance of clients and engagements,[9] during engagement planning or while obtaining an understanding of an entity's internal control, or while conducting fieldwork.[10] Also, other conditions may be identified during fieldwork that change or support a judgment regarding the assessment— such as the following:

- *Discrepancies in the accounting records,* including —
  - — Transactions not recorded in a complete or timely manner or improperly recorded as to amount, accounting period, classification, or entity policy.
  - — Unsupported or unauthorized balances or transactions.
  - — Last-minute adjustments by the entity that significantly affect financial results.
- *Conflicting or missing evidential matter,* including —
  - — Missing documents.
  - — Unavailability of other than photocopied documents when documents in original form are expected to exist.
  - — Significant unexplained items on reconciliations.

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[8] SAS No. 55, as amended by SAS No. 78, paragraph 47, states that assessing control risk at below the maximum level involves identifying specific controls that are likely to prevent or detect material misstatements in those assertions, and performing tests of controls to evaluate their effectiveness.

[9] See Statement on Quality Control Standards No. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (AICPA, *Professional Standards,* vol. 2, QC sec. 20), paragraphs 14 through 16.

[10] The auditor also ordinarily obtains written representations from management concerning irregularities involving management and employees that could have a material effect on the financial statements (see SAS No. 19, *Client Representations* [AICPA, *Professional Standards,* vol. 1, AU sec. 333]).

- — Inconsistent, vague, or implausible responses from management or employees arising from inquiries or analytical procedures.
- — Unusual discrepancies between the entity's records and confirmation replies.
- — Missing inventory or physical assets of significant magnitude.

- *Problematic or unusual relationships between the auditor and client,* including —
  - — Denied access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought.[11]
  - — Undue time pressures imposed by management to resolve complex or contentious issues.
  - — Unusual delays by the entity in providing requested information.
  - — Tips or complaints to the auditor about fraud.

## The Auditor's Response to the Results of the Assessment

26. A risk of material misstatement due to fraud is always present to some degree. The auditor's response to the foregoing assessment is influenced by the nature and significance of the risk factors identified as being present. In some cases, even though fraud risk factors have been identified as being present, the auditor's judgment may be that audit procedures otherwise planned are sufficient to respond to the risk factors. In other circumstances, the auditor may conclude that the conditions indicate a need to modify procedures.[12] In these circumstances, the auditor should consider whether the assessment of the risk of material misstatement due to fraud calls for an overall response, one

[11] Denial of access to information may constitute a limitation on the scope of the audit that may require the auditor to consider qualifying or disclaiming an opinion on the financial statements (see SAS No. 58, as amended, *Reports on Audited Financial Statements* [AICPA, *Professional Standards,* vol. 1, AU sec. 508], paragraphs 22 through 32).

[12] SAS No. 47, as amended by this Statement, requires the auditor to limit audit risk to a low level that is, in the auditor's professional judgment, appropriate for expressing an opinion on the financial statements.

that is specific to a particular account balance, class of transactions or assertion, or both. The auditor also may conclude that it is not practicable to modify the procedures that are planned for the audit of the financial statements sufficiently to address the risk. In that case withdrawal from the engagement with communication to the appropriate parties may be an appropriate course of action (see paragraph 36).

## Overall Considerations

27. Judgments about the risk of material misstatement due to fraud may affect the audit in the following ways:

- *Professional skepticism.* Due professional care requires the auditor to exercise professional skepticism—that is, an attitude that includes a questioning mind and critical assessment of audit evidence (see SAS No. 1, AU sec. 230, "Due Professional Care in the Performance of Work," paragraphs 7 through 9, as amended by this Statement). Some examples demonstrating the application of professional skepticism in response to the auditor's assessment of the risk of material misstatement due to fraud include (*a*) increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions, and (*b*) increased recognition of the need to corroborate management explanations or representations concerning material matters—such as further analytical procedures, examination of documentation, or discussion with others within or outside the entity.
- *Assignment of personnel.* The knowledge, skill, and ability of personnel assigned significant engagement responsibilities should be commensurate with the auditor's assessment of the level of risk of the engagement (see SAS No. 1 [AICPA, *Professional Standards*, vol. 1, AU sec. 210, "Training and Proficiency of the Independent Auditor," paragraph 3]). In addition, the extent of supervision should recognize the risk of material misstatement due to fraud and the qualifications of persons performing the work (see SAS No. 22, paragraph 11).
- *Accounting principles and policies.* The auditor may decide to consider further management's selection and application of significant accounting policies, particularly those related to revenue recognition, asset valuation, or capitalizing versus expensing. In this respect, the auditor may have a greater concern about whether the account-

ing principles selected and policies adopted are being applied in an inappropriate manner to create a material misstatement of the financial statements.

- *Controls.* When a risk of material misstatement due to fraud relates to risk factors that have control implications, the auditor's ability to assess control risk below the maximum may be reduced. However, this does not eliminate the need for the auditor to obtain an understanding of the components of the entity's internal control sufficient to plan the audit (see SAS No. 55, as amended by SAS No. 78). In fact, such an understanding may be of particular importance in further understanding and considering any controls (or lack thereof) the entity has in place to address the identified fraud risk factors. However, this consideration also would need to include an added sensitivity to management's ability to override such controls.

28. The nature, timing, and extent of procedures may need to be modified in the following ways:

- The *nature* of audit procedures performed may need to be changed to obtain evidence that is more reliable or to obtain additional corroborative information. For example, more evidential matter may be needed from independent sources outside the entity. Also, physical observation or inspection of certain assets may become more important. (See SAS No. 31, *Evidential Matter,* as amended [AICPA, *Professional Standards,* vol. 1, AU sec. 326], paragraphs 19 through 22.)
- The *timing* of substantive tests may need to be altered to be closer to or at year end. For example, if there are unusual incentives for management to engage in fraudulent financial reporting, the auditor might conclude that substantive testing should be performed near or at year end because it would not otherwise be possible to control the incremental audit risk associated with that risk factor. (See SAS No. 45, *Omnibus Statement on Auditing Standards—1983* [AICPA, *Professional Standards,* vol. 1, AU sec. 313, "Substantive Tests Prior to the Balance-Sheet Date"], paragraph 6.)
- The *extent* of the procedures applied should reflect the assessment of the risk of material misstatement due to fraud. For example, increased sample sizes or more extensive analytical procedures may be appropriate. (See SAS No. 39, *Audit Sampling* [AICPA, *Professional Standards,* vol. 1, AU sec. 350], paragraph 23, and SAS No. 56, *Analytical Procedures* [AICPA, *Professional Standards,* vol. 1, AU sec. 329].)

## Considerations at the Account Balance, Class of Transactions, and Assertion Level

29. Specific responses to the auditor's assessment of the risk of material misstatement due to fraud will vary depending upon the types or combinations of fraud risk factors or conditions identified and the account balances, classes of transactions, and assertions they may affect. If these factors or conditions indicate a particular risk applicable to specific account balances or types of transactions, audit procedures addressing these specific areas should be considered that will, in the auditor's judgment, limit audit risk to an appropriate level in light of the risk factors or conditions identified. The following are specific examples of responses:

- Visit locations or perform certain tests on a surprise or unannounced basis — for example, observing inventory at locations where auditor attendance has not been previously announced or counting cash at a particular date on a surprise basis.
- Request that inventories be counted at a date closer to year end.
- Alter the audit approach in the current year — for example, contacting major customers and suppliers orally in addition to written confirmation, sending confirmation requests to a specific party within an organization, or seeking more and different information.
- Perform a detailed review of the entity's quarter-end or year-end adjusting entries and investigate any that appear unusual as to nature or amount.
- For significant and unusual transactions, particularly those occurring at or near year end, investigate (*a*) the possibility of related parties and (*b*) the sources of financial resources supporting the transactions.[13]
- Perform substantive analytical procedures at a detailed level. For example, compare sales and cost of sales by location and line of business to auditor-developed expectations.[14]
- Conduct interviews of personnel involved in areas in which a con-

[13] SAS No. 45, *Omnibus Statement on Auditing Standards—1983* (AICPA, *Professional Standards*, vol. 1, AU sec. 334, "Related Parties"), provides guidance with respect to the identification of related-party relationships and transactions, including transactions that may be outside the ordinary course of business (see paragraph 6 of SAS No. 45).

[14] SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329) provides guidance on performing analytical procedures used as substantive tests.

cern about the risk of material misstatement due to fraud is present, to obtain their insights about the risk and whether or how controls address the risk.

- When other independent auditors are auditing the financial statements of one or more subsidiaries, divisions, or branches, consider discussing with them the extent of work necessary to be performed to ensure that the risk of material misstatement due to fraud resulting from transactions and activities among these components is adequately addressed.
- If the work of a specialist becomes particularly significant with respect to its potential impact on the financial statements, perform additional procedures with respect to some or all of the specialist's assumptions, methods, or findings to determine that the findings are not unreasonable or engage another specialist for that purpose. (See SAS No. 73, *Using the Work of a Specialist* [AICPA, *Professional Standards,* vol. 1, AU sec. 336], paragraph 12.)

## Specific Responses — Misstatements Arising From Fraudulent Financial Reporting

30. Some examples of responses to the auditor's assessment of the risk of material misstatements arising from fraudulent financial reporting are —

- ***Revenue recognition.*** If there is a risk of material misstatement due to fraud that may involve or result in improper revenue recognition, it may be appropriate to confirm with customers certain relevant contract terms and the absence of side agreements — inasmuch as the appropriate accounting is often influenced by such terms or agreements.[15] For example, acceptance criteria, delivery

[15] SAS No. 67, *The Confirmation Process* (AICPA, *Professional Standards,* vol. 1, AU sec. 330), provides guidance about the confirmation process in audits performed in accordance with generally accepted auditing standards. Among other considerations, that guidance discusses the types of respondents from whom confirmations may be requested, and what the auditor should consider if information about the respondent's competence, knowledge, motivation, ability, or willingness to respond, or about the respondent's objectivity and freedom from bias with respect to the audited entity comes to his or her attention (AU sec. 330.27). It also provides that the auditor maintain control over the confirmation requests and responses in order to minimize the possibility that the results will be biased because of interception and alteration of the confirmation requests or responses (AU sec. 330.28). Further, when confirmation responses are other than in written communications mailed to the auditor, additional

and payment terms and the absence of future or continuing vendor obligations, the right to return the product, guaranteed resale amounts, and cancellation or refund provisions often are relevant in such circumstances.

- ***Inventory quantities.*** If a risk of material misstatement due to fraud exists in inventory quantities, reviewing the entity's inventory records may help to identify locations, areas, or items for specific attention during or after the physical inventory count. Such a review may lead to a decision to observe inventory counts at certain locations on an unannounced basis (see paragraph 29). In addition, where the auditor has a concern about the risk of material misstatement due to fraud in the inventory area, it may be particularly important that the entity counts are conducted at all locations subject to count on the same date. Furthermore, it also may be appropriate for the auditor to apply additional procedures during the observation of the count — for example, examining more rigorously the contents of boxed items, the manner in which the goods are stacked (for example, hollow squares) or labeled, and the quality (that is, purity, grade, or concentration) of liquid substances such as perfumes or specialty chemicals. Finally, additional testing of count sheets, tags or other records, or the retention of copies may be warranted to minimize the risk of subsequent alteration or inappropriate compilation.

## Specific Responses — Misstatements Arising From Misappropriations of Assets

31. The auditor may have identified a risk of material misstatement due to fraud relating to misappropriation of assets. For example, the auditor may conclude that such a risk of asset misappropriation at a particular operating location is significant. This may be the case when a specific type of asset is particularly susceptible to such a risk of misappropriation — for example, a large amount of easily accessible cash, or inventory items such as jewelry, that can be easily moved and sold. Control risk may be evaluated differently in each of these situations. Thus, differing circumstances necessarily would dictate different responses.

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evidence, such as verifying the source and contents of a facsimile response in a telephone call to the purported sender, may be required to support their validity (AU sec. 330.29).

32. Usually the audit response to a risk of material misstatement due to fraud relating to misappropriation of assets will be directed toward certain account balances and classes of transactions. Although some of the audit responses noted in paragraphs 29 and 30 may apply in such circumstances, the scope of the work should be linked to the specific information about the misappropriation risk that has been identified. For example, where a particular asset is highly susceptible to misappropriation that is potentially material to the financial statements, obtaining an understanding of the control activities related to the prevention and detection of such misappropriation and testing the operating effectiveness of such controls may be warranted. In certain circumstances, physical inspection of such assets (for example, counting cash or securities) at or near year end may be appropriate. In addition, the use of substantive analytical procedures, including the development by the auditor of an expected dollar amount, at a high level of precision, to be compared with a recorded amount, may be effective in certain circumstances.

## Evaluation of Audit Test Results

33. As indicated in paragraph 25, the assessment of the risk of material misstatement due to fraud is a cumulative process and one that should be ongoing throughout the audit. At the completion of the audit, the auditor should consider whether the accumulated results of audit procedures and other observations (for example, conditions noted in paragraph 25) affect the assessment of the risk of material misstatement due to fraud he or she made when planning the audit. This accumulation is primarily a qualitative matter based on the auditor's judgment. Such an accumulation may provide further insight into the risk of material misstatement due to fraud and whether there is a need for additional or different audit procedures to be performed.

34. When audit test results identify misstatements in the financial statements, the auditor should consider whether such misstatements may be indicative of fraud.[16] If the auditor has determined that misstatements are or may be the result of fraud, but the effect of the misstatements is not material to the financial statements, the auditor nevertheless should evaluate the implications, especially those dealing

[16] See note 3.

with the organizational position of the person(s) involved. For example, fraud involving misappropriations of cash from a small petty cash fund normally would be of little significance to the auditor in assessing the risk of material misstatement due to fraud because both the manner of operating the fund and its size would tend to establish a limit on the amount of potential loss and the custodianship of such funds is normally entrusted to a relatively low-level employee.[17] Conversely, when the matter involves higher level management, even though the amount itself is not material to the financial statements, it may be indicative of a more pervasive problem. In such circumstances, the auditor should reevaluate the assessment of the risk of material misstatement due to fraud and its resulting impact on (*a*) the nature, timing, and extent of the tests of balances or transactions, (*b*) the assessment of the effectiveness of controls if control risk was assessed below the maximum, and (*c*) the assignment of personnel that may be appropriate in the circumstances.

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

*a.* Consider the implications for other aspects of the audit (see previous paragraph).

*b.* Discuss the matter and the approach to further investigation with an appropriate level of management that is at least one level above those involved and with senior management.

*c.* Attempt to obtain additional evidential matter to determine whether material fraud has occurred or is likely to have occurred, and, if so, its effect on the financial statements and the auditor's report thereon.[18]

*d.* If appropriate, suggest that the client consult with legal counsel.

36. The auditor's consideration of the risk of material misstatement due to fraud and the results of audit tests may indicate such a significant risk of fraud that the auditor should consider withdrawing from the engagement and communicating the reasons for withdrawal to the audit committee or others with equivalent authority and responsibility (here-

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[17] However, see paragraph 38 for a discussion of the auditor's communication responsibilities.

[18] See SAS No. 58 for guidance on auditors' reports issued in connection with audits of financial statements.

after referred to as the audit committee).[19, 20] Whether the auditor concludes that withdrawal from the engagement is appropriate may depend on the diligence and cooperation of senior management or the board of directors in investigating the circumstances and taking appropriate action. Because of the variety of circumstances that may arise, it is not possible to describe definitively when withdrawal is appropriate. The auditor may wish to consult with his or her legal counsel when considering withdrawal from an engagement.

# Documentation of the Auditor's Risk Assessment and Response

37. In planning the audit, the auditor should document in the working papers evidence of the performance of the assessment of the risk of material misstatement due to fraud (see paragraphs 12 through 14). Where risk factors are identified as being present, the documentation should include (*a*) those risk factors identified and (*b*) the auditor's response (see paragraphs 26 through 32) to those risk factors, individually or in combination. In addition, if during the performance of the audit fraud risk factors or other conditions are identified that cause the auditor to believe that an additional response is required (paragraph 33), such risk factors or other conditions, and any further response that the auditor concluded was appropriate, also should be documented.

[19] Examples of "others with equivalent authority and responsibility" may include the board of directors, the board of trustees, or the owner in owner-managed entities, as appropriate.

[20] If the auditor, subsequent to the date of the report on the audited financial statements, becomes aware that facts existed at that date which might have affected the report had the auditor then been aware of such facts, the auditor should refer to section 561 of SAS No. 1 (AICPA, *Professional Standards*, vol. 1, AU sec. 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report"), for guidance. Furthermore, paragraph 10 of SAS No. 7, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 315), provides guidance regarding communication to the predecessor auditor.

# Communications About Fraud to Management, the Audit Committee,[21] and Others[22]

38. Whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. This is generally appropriate even if the matter might be considered inconsequential, such as a minor defalcation by an employee at a low level in the entity's organization. Fraud involving senior management and fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statements should be reported directly to the audit committee. In addition, the auditor should reach an understanding with the audit committee regarding the expected nature and extent of communications about misappropriations perpetrated by lower-level employees.

39. When the auditor, as a result of the assessment of the risk of material misstatement due to fraud, has identified risk factors that have continuing control implications (whether or not transactions or adjustments that could be the result of fraud have been detected), the auditor should consider whether these risk factors represent reportable conditions relating to the entity's internal control that should be communicated to senior management and the audit committee.[23] (See SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* [AICPA, *Professional Standards,* vol. 1, AU sec. 325].) The auditor also may wish to communicate other risk factors identified when actions can be reasonably taken by the entity to address the risk.

40. The disclosure of possible fraud to parties other than the client's senior management and its audit committee ordinarily is not part of the auditor's responsibility and ordinarily would be precluded by the auditor's ethical or legal obligations of confidentiality unless the matter is reflected in the auditor's report. The auditor should recognize, however,

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[21] See note 19.

[22] The requirements to communicate noted in paragraphs 38 through 40 extend to any intentional misstatement of financial statements (see paragraph 3). However, the communication may utilize terms other than *fraud* — for example, *irregularity, intentional misstatement, misappropriation, defalcation* — if there is possible confusion with a legal definition of fraud or other reason to prefer alternative terms.

[23] Alternatively, the auditor may decide to communicate solely with the audit committee.

that in the following circumstances a duty to disclose outside the entity may exist:

*a.* To comply with certain legal and regulatory requirements[24]

*b.* To a successor auditor when the successor makes inquiries in accordance with SAS No. 7, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards,* vol. 1, AU sec. 315)[25]

*c.* In response to a subpoena

*d.* To a funding agency or other specified agency in accordance with requirements for the audits of entities that receive governmental financial assistance

Because potential conflicts with the auditor's ethical and legal obligations for confidentiality may be complex, the auditor may wish to consult with legal counsel before discussing matters covered by paragraphs 38 through 40 with parties outside the client.

## Effective Date

41. This Statement is effective for audits of financial statements for periods ending on or after December 15, 1997. Early application of the provisions of this Statement is permissible.

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[24] These requirements include reports in connection with the termination of the engagement, such as when the entity reports an auditor change under the appropriate securities law on Form 8-K and the fraud or related risk factors constitute a "reportable event" or is the source of a "disagreement," as these terms are defined in Item 304 of Regulation S-K. These requirements also include reports that may be required, under certain circumstances, pursuant to the Private Securities Litigation Reform Act of 1995 (codified in section 10A(b)1 of the Securities Exchange Act of 1934) relating to an illegal act that has a material effect on the financial statements.

[25] In accordance with SAS No. 7, communication between predecessor and successor auditors requires the specific permission of the client.

# Appendix A

## Amendment to "Responsibilities and Functions of the Independent Auditor"

*(Amends Statement on Auditing Standards No. 1, AICPA,* **Professional Standards,** *vol. 1, AU sec. 110.)*

1. This amendment adds a new paragraph 2 (and renumbers the existing paragraphs 2 through 9) to include a statement of the auditor's responsibility, in an audit conducted in accordance with generally accepted auditing standards, for the detection of material misstatement in the financial statements due to fraud. The Auditing Standards Board (ASB) believes that the revised description of that presently existing responsibility is more understandable because its structure parallels the description of the auditor's responsibility contained in the auditor's standard report. The ASB also believes that inclusion of this statement in the general standards should heighten the auditor's awareness of the extent of the current responsibility in an audit for the detection of material misstatement due to fraud. New language is shown in boldface italics. The amendment is effective for audits of financial statements for periods ending on or after December 15, 1997. Early application of the provisions of this Statement is permissible.

> ***2. The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.[1] 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.[2] 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.***

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[1] *See SAS No. 47,* **Audit Risk and Materiality in Conducting an Audit,** *as amended by SAS No. 82 (AICPA,* **Professional Standards,** *vol. 1, AU sec, 312), and SAS No. 82,* **Consideration of Fraud in a Financial Statement Audit** *(AICPA,* **Professional Standards,** *vol. 1, AU sec. 316). 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 amounts, the auditor's responsibility to detect misstatements resulting from such illegal acts is the same as that for error or fraud.*

[2] *See SAS No. 1,* **Codification of Auditing Standards and Procedures,** *as amended (AICPA,* **Professional Standards,** *vol. 1, AU sec. 230, "Due Professional Care in the Performance of Work," paragraphs 10 through 13).*

# Appendix B

## Amendment to "Due Care in the Performance of Work"

***(Amends Statement on Auditing Standards No. 1, AICPA,* Professional Standards, *vol. 1, AU sec. 230.)***

1. This amendment includes an expanded discussion of due professional care and reasonable assurance reflected in the change of the section title from "Due Care in the Performance of Work" to "Due Professional Care in the Performance of Work." The objective of these revisions is to heighten the auditor's awareness of the need for professional skepticism throughout the conduct of the audit as well as to articulate clearly the concept of reasonable assurance. New language is shown in boldface italics; deleted language is shown by strike-through. The amendment is effective for audits of financial statements for periods ending on or after December 15, 1997. Early application of the provisions of this Statement is permissible.

1. The third general standard is:

   Due professional care is to be exercised in the ***planning and*** performance of the audit and the preparation of the report.[1]

2. This standard requires the independent auditor to ***plan and*** perform his ***or her*** work with due ***professional*** care. Due ***professional*** care imposes a responsibility upon each ~~person~~ ***professional*** within an independent auditor's organization to observe the standards of field work and reporting. ~~Exercise of due care requires critical review at every level of supervision of the work done and the judgment exercised by those assisting in the audit.~~

3. ~~A paragraph appearing in~~ *Cooley on Torts,* ***a legal treatise,*** ~~often cited by attorneys in discussing due care merits quotation here~~ ***describes the obligation for due care as follows:***

   Every man who offers his services to another and is employed assumes the duty to exercise in the employment such skill as he possesses with reasonable care and diligence. In all these employments where peculiar skill is requisite, if one offers his services, he is understood as holding himself out to the public as possessing the degree of skill commonly possessed by others in the same employment, and if his pretentions are unfounded, he commits a species of fraud upon every man who employs him in reliance on his public profession. But no man, whether skilled or unskilled, undertakes that the task he assumes shall be performed successfully, and without fault or error; he undertakes for good faith and integrity, but not for infallibility, and he is liable to his employer for negligence, bad faith, or dishonesty, but not for losses consequent upon pure errors of judgment.[2]

4. The matter of due ***professional*** care concerns what the independent auditor does and how well he ***or she*** does it. ***The quotation from* Cooley on Torts**

[1] ***This amendment revises the third general standard of the ten generally accepted auditing standards.***

[2] ***D. Haggard,* Cooley on Torts, *472 (4th ed., 1932).***

*provides a source from which an auditor's responsibility for conducting an audit with due professional care can be derived. The remainder of the Statement discusses the auditor's responsibility in the context of an audit.*

*5. An auditor should possess "the degree of skill commonly possessed" by other auditors and should exercise it with "reasonable care and diligence" (that is, with due professional care).*

*6. Auditors should be assigned to tasks and supervised commensurate with their level of knowledge, skill, and ability so that they can evaluate the audit evidence they are examining. The auditor with final responsibility for the engagement should know, at a minimum, the relevant professional accounting and auditing standards and should be knowledgeable about the client.*[3] *The auditor with final responsibility is responsible for the assignment of tasks to, and supervision of, assistants.*[4]

## Professional Skepticism

*7. Due professional care requires the auditor to exercise* professional skepticism. *Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor uses the knowledge, skill, and ability called for by the profession of public accounting to diligently perform, in good faith and with integrity, the gathering and objective evaluation of evidence.*

*8. Gathering and objectively evaluating audit evidence requires the auditor to consider the competency and sufficiency of the evidence. Since evidence is gathered and evaluated throughout the audit, professional skepticism should be exercised throughout the audit process.*

*9. The auditor neither assumes that management is dishonest nor assumes unquestioned honesty. In exercising professional skepticism, the auditor should not be satisfied with less than persuasive evidence because of a belief that management is honest.*

## Reasonable Assurance

*10. The exercise of due professional care allows the auditor to obtain* reasonable assurance *that the financial statements are free of material misstatement, whether caused by error or fraud. Absolute assurance is not attainable because of the nature of audit evidence and the characteristics of fraud. Therefore, an audit conducted in accordance with generally accepted auditing standards may not detect a material misstatement.*

*11. The independent auditor's objective is to obtain sufficient competent evidential matter to provide him or her with a reasonable basis for forming an opinion. The nature of most evidence derives, in part, from the concept of selective testing of the data being audited, which involves judgment regarding both the areas to be tested and the nature, timing, and extent of the tests to be performed. In addition, judgment is required in interpreting the results*

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[3] *See SAS No. 22,* Planning and Supervision *(AICPA,* Professional Standards, *vol. 1, AU sec. 311), paragraph 7.*

[4] *See SAS No. 22, paragraph 11.*

*of audit testing and evaluating audit evidence. Even with good faith and integrity, mistakes and errors in judgment can be made. Furthermore, accounting presentations contain accounting estimates, the measurement of which is inherently uncertain and depends on the outcome of future events. The auditor exercises professional judgment in evaluating the reasonableness of accounting estimates based on information that could reasonably be expected to be available prior to the completion of field work.*[5] *As a result of these factors, in the great majority of cases, the auditor has to rely on evidence that is persuasive rather than convincing.*[6]

*12. Because of the characteristics of fraud, particularly those involving concealment and falsified documentation (including forgery), a properly planned and performed audit may not detect a material misstatement. For example, an audit conducted in accordance with generally accepted auditing standards rarely involves authentication of documentation, nor are auditors trained as or expected to be experts in such authentication. Also, auditing procedures may be ineffective for detecting an intentional misstatement that is concealed through collusion among client personnel and third parties or among management or employees of the client.*

*13. Since the auditor's opinion on the financial statements is based on the concept of obtaining reasonable assurance, the auditor is not an insurer and his or her report does not constitute a guarantee. Therefore, the subsequent discovery that a material misstatement, whether from error or fraud, exists in the financial statements does not, in and of itself, evidence* (a) *failure to obtain reasonable assurance,* (b) *inadequate planning, performance, or judgment,* (c) *the absence of due professional care, or* (d) *a failure to comply with generally accepted auditing standards.*

[5] *See* SAS *No.* 57, Auditing Accounting Estimates *(AICPA,* Professional Standards, *vol. 1, AU sec. 342), paragraph 22.*

[6] *See* SAS *No. 31,* Evidential Matter, *as amended (AICPA,* Professional Standards, *vol. 1, AU sec. 326).*

# Appendix C

## Amendment to *Audit Risk and Materiality in Conducting an Audit*

***(Amends Statement on Auditing Standards No. 47, AICPA,* Professional Standards, *vol. 1, AU sec. 312.)***

1. This amendment revises SAS No. 47, *Audit Risk and Materiality in Conducting an Audit,* to provide a foundation within the audit risk model for the consideration of fraud and to incorporate guidance on errors that was formerly included in SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (AICPA, *Professional Standards,* vol. 1, AU sec. 316), which is superseded by this SAS. The revisions also (*a*) elaborate on factors an auditor should consider for an entity with multiple locations or components and (*b*) include changes to conform to the definition and description of internal control contained in SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AICPA, *Professional Standards,* vol. 1, AU sec. 319). New language is shown in boldface italics; deleted language is shown by strike-through. The amendment is effective for audits of financial statements for periods ending on or after December 15, 1997. Early application of the provisions of this Statement is permissible.

> 1. This Statement 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.
>
> 2. The existence of audit risk is recognized ~~by the statement in the auditor's standard report that the auditor obtained "reasonable assurance" about whether the financial statements are free of material misstatement.[+]~~ ***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 risk[2] is the risk that the auditor may unknowingly fail

~~[+] For purposes of this section, misstatements includes both errors and irregularities as defined in SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities,* paragraphs 2–3.~~

[1] ***See SAS No. 1,* Codification of Auditing Standards and Procedures, *as amended by SAS No. 82 (AICPA,* Professional Standards, *vol. 1, AU sec. 110, "Responsibilities and Functions of the Independent Auditor") and SAS No. 1 (AICPA,* Professional Standards, *vol. 1, AU sec. 230, "Due Professional Care in the Performance of Work"), for a further discussion of reasonable assurance.***

[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

*(continued)*

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. The phrase ***in the auditor's standard report*** "present fairly, 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.

4. 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 result from misapplications of generally accepted accounting principles, departures from fact, or omissions of necessary information.~~ ***Misstatements can result from errors or fraud.***[5]

***5. 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.***

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financial statements ~~that he has~~ audited and reported on. This exposure is present even though the auditor has performed ~~his~~ ***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, ~~he~~ ***the auditor*** should not perform less extensive procedures than would otherwise be 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, ~~he~~ ***the auditor*** would ordinarily reconsider or extend ~~his~~ auditing procedures and request that the client perform specific tasks to reevaluate 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 ~~an uncertainty or~~ ***a*** limitation on the scope of the audit.

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

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

***6. 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.*[6]**

***7. 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 SAS No. 82,* 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.***

***8. 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.***

~~5.~~ ***9.*** When ~~reaching a conclusion~~ ***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.

~~6.~~ ***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

[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.***

surrounding circumstances and necessarily involve both quantitative and qualitative considerations.

~~7.~~ ***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. ~~[5]~~ [7]

## Planning the Audit

~~8.~~ ***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.

### Considerations at the Financial Statements Level [6]

~~9.~~ ***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 ~~issuing~~ ***expressing*** an opinion on the financial statements. Audit risk may be assessed in quantitative or nonquantitative terms.

~~10.~~ ***14.*** SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards,* vol. 1, AU sec. 311), 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. ~~[7]~~ [8] That judgment may or may not be quantified.

~~11.~~ ***15.*** According to SAS No. 22, 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 ~~17~~ ***24*** through ~~26~~ **33**.)

***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.[9] In considering audit risk, the auditor***

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~~[5]~~ [7] ~~The auditor's responsibility for illegal acts is discussed in~~ ***See*** SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards,* vol. 1, AU sec. 317).

[6] ~~See SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, paragraphs 10–12, for a further discussion of the consideration of audit risk at the financial statement level.~~

~~[7]~~ [8] This Statement amends SAS No. 22, *Planning and Supervision,* paragraph 3e, by substituting the words "Preliminary judgment about materiality levels" in place of the words "Preliminary estimates of materiality levels."

[9] ***See SAS No. 55, as amended by SAS No. 78,*** **Consideration of Internal Control in a Financial Statement Audit** ***(AICPA,*** **Professional Standards,** ***vol. 1, AU sec. 319).***

***should specifically assess the risk of material misstatement of the financial statements due to fraud.*[10] *The auditor should consider the effect of these assessments on the overall audit strategy and the expected conduct and scope of the audit.***

***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 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.***

***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.***

~~12.~~ ***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 ~~him~~, within the inherent limitations of the auditing process, ~~with~~ 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 ~~he~~ ***the auditor*** believes that misstatements aggregating approximately $100,000 would have a 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.

~~13.~~ ***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 ordi-

[10] ***See SAS No. 82,*** **Consideration of Fraud in a Financial Statement Audit.**

narily is not practical to design procedures to detect them. SAS No. 31, *Evidential Matter*, ***as amended*** (AICPA, *Professional Standards,* vol. 1, AU sec. 326), states that "an auditor typically works within economic limits; the auditor's opinion, to be economically useful, must be formed within a reasonable length of time and at reasonable cost."

~~14.~~ ***21.*** In some situations, the auditor considers materiality for planning purposes before the financial statements to be audited are prepared. In other situations, ~~his~~ planning takes place after the financial statements under audit have been prepared, but ~~he~~ ***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 he gives~~ 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.

~~15.~~ ***22***. Assuming, theoretically, that the auditor's judgment about materiality at the planning stage was based on the same information available ~~to him~~ 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 ~~his~~ judgments about materiality in evaluating the audit findings at the completion of the audit. Thus, ~~his~~ ***the auditor's*** preliminary judgment about materiality ordinarily will differ from ~~his~~ ***the*** judgment about materiality used in evaluating the audit findings. If significantly lower materiality levels become appropriate in evaluating ~~his~~ audit findings, the auditor should reevaluate the sufficiency of the auditing procedures he ***or she*** has performed.

~~16.~~ ***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.

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

~~17.~~ ***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 ~~he~~ ***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*** ~~the balance-sheet date~~, or (*c*) increase the extent of a particular auditing procedure.

~~18.~~ ***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 ~~his~~ ***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.

~~19.~~ ***26.*** The auditor needs to consider audit risk at the individual account-balance or class-of-transactions level because such consideration directly assists ~~him~~ 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 ~~his~~ ***the*** examination, 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.~~ ***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 balance***s*** 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.[*11] The way the auditor considers these component risks and combines them involves professional judgment and depends on ~~his~~ ***the*** audit approach.

*a.* *Inherent risk* is the susceptibility of an assertion to a material misstatement, assuming that there are no related ~~internal~~ control***s*** ~~structure policies or procedures~~. The risk of such missta***te***ment 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. ~~(See SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, paragraph 10.)~~

*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 entity's internal

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[*11] The formula in the appendix (paragraph 48) to SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350), 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.

control ~~structure policies or procedures~~. That risk is a function of the effectiveness of the design and operation of internal control ~~structure policies or procedures~~ in achieving the entity's ~~broad internal control structure~~ objectives relevant to ~~an audit~~ ***preparation*** of the entity's financial statements. Some control risk will always exist because of the inherent limitations of ~~any~~ internal control ~~structure~~.

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.

~~21.~~ ***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 ~~he~~ ***that*** can ***be*** accept***ed.*** Conversely, the greater the inherent and control risk the auditor believes exists, the less the detection risk ~~he~~ ***that*** can ***be*** accept***ed.*** 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.

~~22.~~ ***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, ~~he~~ ***the auditor*** considers not only factors peculiar to the related assertion, but also, other factors pervasive to the financial statements taken as a 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 ~~his~~ auditing procedures derived from such an assessment, ~~he~~ ***the auditor*** should assess inherent risk as being at the maximum when designing auditing procedures.

~~23.~~ ***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 ~~structure policies or procedures~~ in preventing or detecting misstatements in financial statement assertions. If the auditor believes control***s*** ~~structure policies or procedures~~ are unlikely to pertain to an assertion or are unlikely to be effective, or ~~if he~~ believes that evaluating their effectiveness would be inefficient, he ***or she*** would assess control risk for that assertion at the maximum.

~~24.~~ ***31.*** The auditor might make separate or combined assessments of inherent risk and control risk. If ~~he~~ ***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 ~~his~~ ***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, ~~his~~ ***the*** understanding of ~~the~~ internal control ~~structure~~ and ~~his~~ ***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.

~~25.~~ ***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 ~~his~~ ***the*** assessment of inherent and control risks. As the auditor's assessment of inherent risk and control risk decreases, the detection risk that ~~he~~ can ***be*** accept***ed*** increases. It is not appropriate, however, for an auditor to rely completely on ~~his~~ assessments of inherent risk and control risk to the 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.

~~26.~~ ***33.*** An audit of financial statements is a cumulative process; as the auditor performs planned auditing procedures, the evidence ~~he obtains~~ ***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,*** ~~I~~information may come to the auditor's attention ~~as result of performing auditing procedures or from other sources during the audit~~ that differs significantly from the information on which ~~his~~ ***the*** audit plan was based. For example, the extent of misstatements ~~he detects~~ ***detected*** may alter ~~his~~ ***the*** judgment about the levels of inherent and control risks, and other information ~~he obtains~~ ***obtained*** about the financial statements may alter ~~his~~ ***the*** preliminary judgment about materiality. In such cases, ~~he~~ ***the auditor*** may need to reevaluate the auditing procedures he ***or she*** plans to apply, based on ~~his~~ ***the*** revised consideration of audit risk and materiality for all or certain of the account balances or classes of transactions and related assertions.

## Evaluating Audit Findings

~~27.~~ ***34.*** In evaluating whether the financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, the auditor should aggregate misstatements that the entity has not corrected in a way that enables him ***or her*** 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 ~~an~~ ***the*** auditor in reaching a conclusion as to whether misstatements are material.

~~28.~~ ***35.*** The 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 misstatement~~*~~[12]), not just the amount of misstatements ~~he~~ specifically identifie~~s~~***d*** (hereafter referred to as known misstatement).~~**~~[13] When the auditor tests an account balance or ***a*** class of trans-

~~*~~[12] See SAS No. ~~53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*,~~ ***82*, Consideration of Fraud in a Financial Statement Audit,** paragraphs ~~22–25,~~ ***33–35,*** for a further discussion of the auditor's consideration of differences between the accounting records and the underlying facts and circumstances. ~~This section~~ ***Those paragraphs*** provide~~s~~ specific guidance on the auditor's consideration of an audit adjustment that is, or may be, ~~an irregularity~~ ***the result of fraud.***

~~**~~[13] If the auditor were to examine all of the items in a balance or class, the likely misstatement applicable to recorded transactions in the balance or class would be the amount of known misstatements specifically identified.

actions 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 ~~he~~ identified in ~~his~~ ***the*** sample to the items in the balance or class from which ~~his~~ ***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.

~~29.~~ ***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 and aggregate it with other likely misstatements. 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***s*** 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.

~~30.~~ ***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.~~[11]~~[14] 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, ~~he~~ ***the auditor*** should include in aggregate likely misstatement the effect on the current period's financial statements of those prior-period likely misstatements.

~~31.~~ ***38.*** If the auditor concludes, based on ~~his~~ ***the*** accumulation of sufficient evidential matter, that the aggregation of likely misstatements causes the financial

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~~[11]~~[14] 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 Statement.

statements to be materially misstated, ~~he~~ ***the auditor*** should request management to eliminate the material misstatement. If the material misstatement is not eliminated, ~~he~~ ***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 aggregate effect 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.

~~32.~~ ***39.*** If the auditor concludes that the aggregation of likely misstatements does not cause the financial statements to be materially misstated, he ***or she*** should recognize that they could still be materially misstated ~~due to~~ ***because of*** further misstatement remaining undetected. As aggregate likely misstatement increases, the risk that the financial statements may be materially misstated also increases. ***The*** ~~A~~***a***uditor~~s~~ generally reduce**s** this risk of material misstatement in planning the audit by restricting the extent of detection risk ~~they are~~ ***he or she is*** willing to accept for an assertion related to an account balance or ***a*** class of transactions. ***The*** ~~A~~***a***uditor~~s~~ ***also*** can ~~also~~ reduce this risk of material misstatement by modifying the nature, timing, and extent of planned auditing procedures on a continuous basis in performing the audit. (See paragraph ~~26~~ **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 statements to reduce the risk of material misstatement to an acceptable level.

***40. In aggregating known and 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.***

## Effective Date

~~33.~~ ***41.*** This Statement is effective for audits of financial statements for periods beginning after June 30, 1984. ***The amendments are effective for audits of financial statements for periods ending on or after December 15, 1997.***

*This Statement entitled* Consideration of Fraud in a Financial Statement Audit *was adopted by the assenting votes of the fifteen members of the board, of whom three, Messrs. McElroy, Rockman, and Vice, assented with qualification.*

Messrs. McElroy, Rockman, and Vice qualify their assent for paragraphs 17 and 19, which list risk factors. They believe that it can be inferred from the Statement that the selection of appropriate risk factors is mandated by the Standard. Also, in paragraph 17, several of the risk factors are supported by specific indicators. These indicators, when taken with the risk factors, create a list of examples far too numerous for the body of a Statement.

They are concerned that, despite the fact that paragraph 14 of the Statement states that "the auditor should use professional judgment when assessing the . . . relevance of fraud risk factors," in practice, auditors may mistakenly believe that they need to consider all of the fraud risk factors in the Statement on every audit.

In practice, the auditor should apply judgment, based on "entities of different size, with different ownership characteristics, in different industries, or because of other differing characteristics or circumstances," as stated in paragraph 14 of the Statement. Further, as business practices and processes change, including the effects of technology, auditors will need to consider risk factors appropriate to changed circumstances.

Messrs. McElroy, Rockman, and Vice believe that the profession and the public would be better served by publishing fewer risk factors within the Statement and by providing example risk factors in nonauthoritative documents that can be better tailored to the circumstances, and that can change over time as new knowledge becomes available.

## Auditing Standards Board (1996)

## Fraud Task Force

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*Technical Manager,*
*Audit and Attest Standards*

**Note:** *Statements on Auditing Standards are issued by the Auditing Standards Board, the senior technical body of the Institute designated to issue pronouncements on auditing matters. Rule 202 of the Institute's Code of Professional Conduct requires compliance with these standards.*