

Chapter 9

Assessing the Risk of Material Misstatement

■ Concept Checks

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1. The risk of material misstatement exists at two levels: the overall financial statement level and at the assertion level for classes of transactions, account balances, and presentation and disclosures. Auditing standards require the auditor to assess the risk of material misstatement at each of these levels and to plan the audit in response to those assessed risks.
2. To obtain an understanding of the entity and its environment, including the entity's internal controls, the auditor performs risk assessment procedures to identify and assess the risk of material misstatement, whether due to fraud or error. Risk assessment procedures include the following:
 - Inquiries of management and others within the entity
 - Analytical procedures
 - Observation and inspection
 - Discussion among engagement team members
 - Other risk assessment procedures

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1. The audit risk model is as follows:

$$PDR = \frac{AAR}{IR \times CR}$$

Where *PDR* = Planned detection risk
AAR = Acceptable audit risk
IR = Inherent risk
CR = Control risk

Planned detection risk A measure of the risk that audit evidence for a segment will fail to detect misstatements that could be material, should such misstatements exist.

Acceptable audit risk A measure of how willing the auditor is to accept that the financial statements may be materially misstated after the audit is completed and an unmodified opinion has been issued.

Inherent risk A measure of the auditor's assessment of the susceptibility of an assertion to material misstatement before considering the effectiveness of internal control.

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Control risk A measure of the auditor's assessment of the risk that a material misstatement could occur in an assertion and not be prevented or detected by the client's internal controls.

Auditing standards note that the combination of inherent risk and control risk reflects the risk of material misstatement.

2. An increase in planned detection risk may be caused by an increase in acceptable audit risk or a decrease in either control risk or inherent risk. A decrease in planned detection risk is caused by the opposite: a decrease in acceptable audit risk or an increase in control risk or inherent risk.

■ Review Questions

9-1 The parts of planning are: accept client and perform initial planning, understand the client's business and industry, perform preliminary analytical procedures, set preliminary judgment of materiality and performance materiality, identify significant risks due to fraud or error, assess inherent risk, understand internal control and assess control risk, and finalize overall audit strategy and audit plan. The evaluation of risk is an explicit component of part five (identify significant risks, including fraud risks), part six (assess inherent risk), and part seven (control risk).

9-2 The risk of material misstatement at the overall financial statement level refers to risks that relate pervasively to the financial statements as a whole and potentially affect a number of different transactions and accounts. It is important for the auditor to consider risks at the overall financial statement level given those risks may increase the likelihood of risks of material misstatement across a number of accounts and assertions for those accounts.

9-3 A number of overarching factors may increase the risks of material misstatement at the overall financial statement level. For example, deficiencies in management's integrity or competence, ineffective oversight by the board of directors, or inadequate accounting systems and records increase the likelihood that material misstatements may be present in a number of assertions affecting several classes of transactions, account balances, or financial statement disclosures. Similarly, declining economic conditions or significant changes in the industry may increase the risk of material misstatement at the overall financial statement level.

9-4 Concern about the client potentially recording revenues that did not occur would relate to the occurrence transaction-related audit objective. In this case, the auditor would assess the risk of occurrence as high.

9-5 The auditor performs risks assessment procedures to identify and assess the risk of material misstatement, whether due to fraud or error. Risk assessment procedures include the following:

1. *Inquiries of management and others within the entity:* Because management and others, including those charged with governance and internal audit, have important information to assist the auditor in identifying risks of material misstatements, the auditor will make a number of inquiries of these individuals to understand the entity and its environment, including internal control, and to ask them about their assessments of the risks of material misstatements.
2. *Analytical procedures:* As noted in Chapter 8, auditors are required to perform preliminary analytical procedures as part of audit planning to better understand the entity and to assess client business risks.
3. *Observation and inspection:* Auditors observe the entity's operations and they inspect documents, such as the organization's strategic plan, business model, and its organizational structure to increase the auditor's understanding of how the business is structured and how it organizes key business functions and leaders in the oversight of day-to-day operations.
4. *Discussion among engagement team members:* Auditing standards require the engagement partner and other key engagement team members to discuss the susceptibility of the client's financial statements to material misstatement. This includes explicit discussion about the susceptibility of the client's financial statements to fraud, in addition to their susceptibility of material misstatement due to errors.
5. *Other risk assessment procedures:* The auditor may perform other procedures to assist in the auditor's assessment of the risk of material misstatement.

9-6 In addition to making inquiries of individuals involved in financial reporting positions, auditors benefit from obtaining information or different perspectives through inquiries of others within the entity and other employees with different levels of authority. Additionally, inquiries of those charged with governance, such as the board of directors or audit committee, may provide important insights about the overall competitive environment and strategy of the business that may provide important insights about overall client business risks. Similarly, because internal auditors typically have exposure to all aspects of the client's business and operations, they may have important information about risks at the overall financial statement level or assertion level. Most internal audit functions develop their internal audit scope based on a risk assessment process that considers risks to design their audit strategies.

9-7 Auditing standards require the engagement partner and other key engagement team members to discuss the susceptibility of the client's financial statements to material misstatement. Discussion among the engagement partner and other key members of the engagement team provides an opportunity for more experienced team members, including the engagement partner, to share

9-7 (continued)

their insights about the entity and its environment, including their understanding of internal controls, with other members of the engagement team. The discussion should include an exchange of ideas or brainstorming among the engagement team members about business risks and how and where the financial statements might be susceptible to material misstatement, whether due to fraud or error. By including key members of the engagement team in discussions with the engagement partner, all members of the engagement team become better informed about the potential for material misstatement of the financial statements in specific areas of the audit assigned to them, and it helps them gain an appreciation for how the results of audit procedures performed by them affect other areas of the audit.

9-8 Auditing standards explicitly require that discussion among engagement team members consider the susceptibility of the client's financial statements to fraud, in addition to their susceptibility of material misstatement due to errors. While auditing standards specifically require a discussion among the key engagement team members, including the engagement partner, about how and where the entity's financial statements may be susceptible to material misstatement due to fraud, this can be held concurrently with the discussion about the susceptibility of the financial statements to material misstatement due to error. These discussions should include an exchange of ideas or brainstorming among the engagement team members about business risks and how and where the financial statements might be susceptible to material misstatement, whether due to fraud or error.

9-9 While auditors perform risk assessment procedures to assess the risk of material misstatement due to fraud or error, auditing standards require the auditor to explicitly consider fraud risk because the risk of not detecting a material misstatement due to fraud is higher than the risk of not detecting a misstatement due to error. Fraud often involves complex and sophisticated schemes designed by perpetrators to conceal it, such as forgery of approvals and authorizations for unusual cash disbursement transactions or intentional efforts to not record a transaction in the accounting records. And, individuals engaged in conducting a fraud often intentionally misrepresent information to the auditor, and they may try to conceal the transaction through collusion with others. As a result, explicitly focusing on the risks of material misstatements due to fraud helps the auditor apply professional skepticism as part of the auditor's planning procedures.

9-10 Because a number of high profile instances of fraudulent financial reporting have involved misstatements in revenue recognition, auditing standards require the auditor to presume that risks of fraud exist in revenue recognition. As a result, risks related to audit objectives for revenue transactions and their related account balances and presentation and disclosure are presumed to be significant risks in most audits. If the auditor determines that the presumption is

9-10 (continued)

not applicable to a particular audit engagement, the auditor must document this conclusion in the working papers.

9-11 Auditing standards require the auditor to inquire of management about their assessment of the risk that the financial statements may be materially misstated due to fraud. As part of those inquiries, the auditor should ask management to describe the frequency of management's assessment and the extent of their consideration of risks due to fraud, including discussion about management's processes that are designed to identify, respond to, and monitor the risks of fraud in the organization. Auditing standards require the auditor to make inquiries of management and others within the entity about their knowledge of any actual, suspected, or alleged fraud affecting the client and whether management has communicated any information about fraud risks to those charged with governance.

9-12 A **significant risk** represents an identified and assessed risk of material misstatement that, in the auditor's professional judgment, requires special audit consideration. Auditing standards require the auditor to obtain an understanding of the entity's controls relevant to significant risks to evaluate the design and implementation of those controls, and the auditor must perform substantive tests related to assertions deemed to have significant risks.

9-13 Three types of characteristics of transactions and balances that might cause an auditor to determine that a risk of material misstatement is a significant risk:

1. **Nonroutine Transactions:** Significant risks often relate to significant nonroutine transactions, which represent transactions that are unusual, either due to size or nature, and that are infrequent in occurrence. Nonroutine transactions may increase the risk of material misstatement because they often involve a greater extent of management intervention, including more reliance on manual versus automated data collection and processing, and they can involve complex calculations or unusual accounting principles not subject to effective internal controls due to their infrequent nature. Related party transactions often reflect these characteristics, thereby increasing the likelihood they are considered significant risks.
2. **Matters Requiring Significant Judgment:** Significant risks also relate to matters that require significant judgment because they include the development of accounting estimates for which significant measurement uncertainty exists. Classes of transactions or account balances that are based on the development of accounting estimates often require significant judgment that is subjective or complex based on assumptions about future events. As a result, those types of transactions or balances frequently are identified as significant risks.

9-13 (continued)

3. **Fraud Risk:** Because fraud generally involves concealment, detecting material misstatements due to fraud is difficult. As a result, when auditors identify a potential risk of material misstatement due to fraud, auditing standards require the auditor to consider that risk a significant risk, which triggers required responses to those risks.

9-14 Inherent risk and control risk relate to the risk of material misstatement at the assertion level. **Inherent risk** measures the auditor's assessment of the susceptibility of an assertion to material misstatement, before considering the effectiveness of related internal controls. **Control risk** measures the auditor's assessment of the risk that a material misstatement could occur in an assertion and not be prevented or detected on a timely basis by the client's internal controls.

9-15 An increase in planned detection risk may be caused by an increase in acceptable audit risk or a decrease in either control risk or inherent risk. A decrease in planned detection risk is caused by the opposite: a decrease in acceptable audit risk or an increase in control risk or inherent risk.

9-16 Inherent risk is a measure of the auditor's assessment of the susceptibility of an assertion to material misstatements before considering the effectiveness of internal control.

Factors affecting assessment of inherent risk include:

- Nature of the client's business
- Results of previous audits
- Initial vs. repeat engagement
- Related parties
- Complex or nonroutine transactions
- Judgment required to correctly record transactions
- Makeup of the population
- Factors related to fraudulent financial reporting
- Factors related to misappropriation of assets

9-17 Inherent risk is set for audit objectives for segments rather than for the overall audit because misstatements occur at the objective level within a segment. By identifying expectations of misstatements in segments, the auditor is thereby able to modify audit evidence by searching for misstatements in those segments.

When inherent risk is increased from medium to high, the auditor should increase the audit evidence accumulated to determine whether the expected misstatement actually occurred.

9-18 Extensive misstatements in the prior year's audit would cause inherent risk to be set at a high level (maybe even 100%). An increase in inherent risk would lead to a decrease in planned detection risk, which would require that the auditor increase the level of planned audit evidence.

9-19 Acceptable audit risk is a measure of how willing the auditor is to accept that the financial statements may be materially misstated after the audit is completed and an unmodified opinion has been issued.

Acceptable audit risk has an inverse relationship to evidence. If acceptable audit risk is reduced, planned evidence should increase.

9-20 When the auditor is in a situation where he or she believes that there is a high exposure to legal liability, the acceptable audit risk would be set lower than when there is little exposure to liability. Even when the auditor believes that there is little exposure to legal liability, there is still a minimum acceptable audit risk that should be met.

9-21 Planned detection risk is the risk that audit evidence for a segment will fail to detect misstatements that could be material, should such misstatements exist. In order to reduce this risk, the auditor would increase the amount of evidence they collect for a specific audit objective. For example, if the auditor wanted a low level of risk that audit procedures designed to test the existence of inventory fail to detect a material misstatement, they would increase the amount of inventory tested and/or the number of audit procedures performed.

9-22 Exact quantification of all components of the audit risk model is not required to use the model in a meaningful way. An understanding of the relationships among model components and the effect that changes in the components have on the amount of evidence needed allow practitioners to use the audit risk model in a meaningful way.

9-23 The auditor should revise the components of the audit risk model when the evidence accumulated during the audit indicates that the auditor's original assessments of inherent risk or control risk are too low or too high or the original assessment of acceptable audit risk is too low or too high.

The auditor should exercise care in determining the additional amount of evidence that will be required. This should be done without the use of the audit risk model. If the audit risk model is used to determine a revised planned detection risk, there is a danger of not increasing the evidence sufficiently.

9-24 Audit risk is a measure of how willing the auditor is to accept that the financial statements may be materially misstated after the audit is completed and an unmodified opinion has been issued. An auditor cannot assess the risk of material misstatement without first deciding the size of misstatements that will be considered material. Materiality and audit risk are considered together in planning the nature and extent of risk assessment procedures to be performed, identifying and assessing the risks of material misstatement, determining the nature, timing and extent of audit procedures, and evaluating audit findings.

■ Multiple Choice Questions From CPA Examinations

9-25 a. (2) b. (1) c. (4)

9-26 a. (3) b. (4) c. (3)

9-27 a. (4) b. (1) c. (1)

■ Multiple Choice Questions From Becker CPA Exam Review

9-28 a. (2) b. (2) c. (1)

■ Discussion Questions And Problems

9-29 a. The following terms are audit planning decisions requiring professional judgment:

- Preliminary judgment about materiality
- Control risk
- Risk of fraud
- Inherent risk
- Risk of material misstatements
- Planned detection risk
- Significant risk
- Acceptable audit risk
- Performance materiality

b. The following terms are audit conclusions resulting from application of audit procedures and requiring professional judgment:

- Estimated total misstatement in a segment
- Estimate of the combined misstatement
- Known misstatement

c. It is acceptable to change any of the factors affecting audit planning decisions at any time in the audit if indicated by changes in circumstances. The planning process begins before the audit starts and continues throughout the engagement. Some of the factors would be least likely to be changed after the audit is 95% completed. For example, the performance materiality or acceptable audit risk would not be raised at the end of the audit after the accumulated audit evidence suggests there are material misstatements that exceed the initial preliminary materiality amount.

9-30 a. PCAOB Auditing Standard No. 12 (paragraph .07) notes that the auditor, when obtaining an understanding of the company and its environment, should obtain an understanding of the following:

1. Relevant industry, regulatory, and other external factors, including the competitiveness of the environment, technological developments, regulations, and the legal and political environment.
2. The nature of the company, including aspects such as its organizational structure, management personnel, sources of funding, significant investments, operating characteristics, sources of earnings, and key suppliers and customers.
3. The company's selection and application of accounting principles, including related disclosures, including an evaluation of whether they are appropriate for its business and consistent with GAAP and with those used in the industry;
4. The company's objectives and strategies and those related business risks that might reasonably be expected to result in risks of material misstatement; and
5. The company's measurement and analysis of its financial performance, including an assessment of how performance measures, whether internal or external, affect the risk of material misstatement.

In obtaining an understanding of the company, the auditor should evaluate whether significant changes in the company from prior periods, including changes in its internal control over financial reporting, affect the risks of material misstatement.

- b. Paragraph .17 of PCAOB Auditing Standard No. 12 provides two examples of performance measures that create incentives or pressures for management to manipulate certain accounts or disclosures to achieve performance targets:
- Measures that form the basis for contractual commitments or incentive compensation plans
 - Measures used by external parties, such as analysts and rating agencies, to review the company's performance

PCAOB Auditing Standard No. 12 also provides the following example of a performance measure that management might use to monitor risks affecting the financial statements:

- Measures the company uses to monitor its operations that highlight unexpected results or trends that prompt management to investigate their cause and take corrective action, including the correction of misstatements.

9-30 (continued)

- c. Paragraphs .49 through .53 of PCAOB Auditing Standard No. 12 require the engagement team members to discuss (1) the company's selection and application of accounting principles, including related disclosure requirements, and (2) the susceptibility of the company's financial statements to material misstatements due to error or fraud. The discussion of potential for material misstatement due to fraud can be done either as part of the discussion regarding risks of material misstatement due to error or separately. Communication about significant matters affecting the risks of material misstatement should continue throughout the audit.

The discussion should include how and where the financial statements might be susceptible to material misstatement, and it should consider known external and internal factors affecting the company that might create incentives or pressures to commit fraud, opportunities to perpetrate the fraud, or indicate a culture or environment that enables management to rationalize committing fraud. The team should also discuss the potential for management override of controls.

- d. When determining whether an identified and assessed risk is a significant risk, paragraphs .70 and .71 of PCAOB Auditing Standard No. 12 note that the determination is based on inherent risk, without regard to the effect of controls. AS No.12 notes that the following factors should be considered:
- The effect of the quantitative and qualitative risk factors on the likelihood and potential magnitude of misstatements
 - Whether the risk is a fraud risk (i.e., a fraud risk is a significant risk)
 - Whether the risk is related to recent significant economic, accounting, or other developments
 - The complexity of transactions
 - Whether the risk involves significant transactions with related parties
 - The degree of complexity or judgment in the recognition or measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty, and
 - Whether the risk involves significant unusual transactions
- e. Paragraph .74 of PCAOB Auditing Standard No. 12 notes that the auditor's assessment of the risks of material misstatement, including fraud risks, should continue throughout the audit. When the auditor obtains audit evidence during the course of the audit that contradicts the audit evidence on which the auditor originally based his or her risk

9-30 (continued)

assessment, the auditor should revise the risk assessment and modify planned audit procedures or perform additional procedures in response to the revised risk assessments.

9-31 a. Several of the recent developments at Highland Bank and Trust may trigger risks of material misstatement at the financial statement level, including the following:

- The integration of the pending acquisition of the small community bank into Highland's operations and financial reporting processes may trigger the potential for misstatements across a number of accounts that must be integrated into the financial reporting system. The accounting for assets and liabilities acquired can be complex and there are a number of valuation and disclosures issues that may lead to increased risks of misstatements in those accounts and disclosures.
- Any challenges associated with the integration of IT systems of the acquired bank with Highland's systems could trigger errors in a number of financial statement accounts, if the IT systems affected impact financial reporting.
- The integrity and competency of personnel from the acquired bank who join Highland could have a pervasive impact on the quality of financial reporting of the combined bank, if they lack integrity or competency.
- Challenges associated with retaining key personnel with IT skills could have a pervasive effect on a number of financial statement accounts, if those individuals leave Highland and there are issues related to the performance of IT systems that impact financial reporting.
- The expansion of online service options for customers could trigger risks across a number of accounts, given customers use online options to make deposits and withdraw funds from both checking and savings accounts. As online service options increase, more financial statement accounts may be impacted.

b. Several of the recent developments at Highland Bank and Trust may trigger risks of material misstatement at the assertion level, including the following:

- The expansion of online service operations may affect the occurrence, completeness, and accuracy of checking and savings account transactions. If there are flaws in the online system, deposits might be overstated due to fictitious deposits or errors in the amounts recorded, thereby affecting the occurrence and accuracy assertions related to those transactions. If transactions are not properly posted to the correct customer accounts,

9-31 (continued)

misstatements related to the posting and summarization transaction-related audit objective may occur.

- Challenges related to credit evaluation may ultimately lead to misstatements in the allowance for loan loss reserves, impacting the realizable value balance-related audit objective (the valuation and allocation assertion). Risks of material misstatements may also affect several of the presentation and disclosure related assertions for loans outstanding, including disclosures related to loan loss reserves.

The expansion into new types of investments subject to fair value accounting where the bank does not have employees with the appropriate valuation skills and competencies increases the risks of material misstatement related to the accuracy and realizable value balance related audit objectives, which impact the valuation and allocation assertion. Risks of material misstatements may also affect several of the presentation and disclosure assertions for investments.

- c. Given the significance of these recent events, the risks noted in answers to part a. and b. would most likely be deemed as significant risks in the current year's audit.

9-32 Acceptable audit risk is a measure of how willing the auditor is to accept that the financial statements may be materially misstated after the audit is completed and an unmodified opinion has been issued.

- a. True. A CPA firm should attempt to use reasonable uniformity from audit to audit when circumstances are similar. The only reasons for having a different audit risk in these circumstances are the lack of consistency within the firm, different audit risk preferences for different auditors, and difficulties of measuring audit risk.
- b. True. Users who rely heavily upon the financial statements need more reliable information than those who do not place heavy reliance on the financial statements. To protect those users, the auditor needs to be reasonably assured that the financial statements are fairly stated. That is equivalent to stating that acceptable audit risk is lower. Consistent with that conclusion, the auditor is also likely to face greatest legal exposure in situations where external users rely heavily upon the statements. Therefore, the auditor should be more certain that the financial statements are correctly stated.
- c. True. The reasoning for c. is essentially the same as for b.

9-32 (continued)

- d. True. The audit opinion issued by different auditors conveys the same meaning regardless of who signs the report. Users cannot be expected to evaluate whether different auditors take different risk levels. Therefore, for a given set of circumstances, every CPA firm should attempt to obtain approximately the same audit risk.

9-33

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|-----|-----------|--|
| 1. | Decrease | Healthier financial condition leads to a decrease in audit risk. |
| 2. | Increase | Audit risk increases when management is dominated by a single person. |
| 3. | Increase | Audit risk increases when internal audit reports to top management rather than the audit committee. |
| 4. | Increase | Audit risk increases when there is turnover in key management positions. |
| 5. | Decrease | The monitoring by the bank loan officer decreases audit risk. |
| 6. | No effect | The timing of payments to employees has no effect on audit risk. |
| 7. | Decrease | Audit risk decreases due to the auditor's previous experience with the client. |
| 8. | Increase | A change in the method of accounting increases the risk of misstatements due to the new reporting method. |
| 9. | Increase | The unusual transaction increases audit risk. |
| 10. | Decrease | The resolution of the lawsuit decreases risk related to disclosure of the litigation. |
| 11. | Increase | Related party transactions increase audit risk. |
| 12. | No effect | The amount of insurance coverage has minimal effect on audit risk. |
| 13. | Increase | The potential for improper revenue recognition increases audit risk. |
| 14. | Increase | A planned stock offering increases incentives to misstate the financial statements and increases audit risk. |

- 9-34** a. Low, medium, and high for the four risks and planned evidence have meaning only in comparison to each other. For example, an acceptable audit risk that is high means the auditor is willing

to accept more risk than in a situation where there is medium risk without specifying the precise percentage of risk. The same is true for the other three risk factors and planned evidence.

b.	1	2	3	4	5	6
Acceptable Audit Risk	H	H	L	L	H	M
IR x CR	L	M	H	M	M	M
PDR = AAR / (IR x CR)	H	M	L	L	M	M
Planned Evidence	L	M	H	H	M	M

L = low, M = medium, H = high

c.

EFFECT ON PDR	EFFECT ON EVIDENCE
(1) Decrease	Increase
(2) Increase	Decrease
(3) NA	Increase
(4) Increase	Decrease
(5) No effect	No effect

9-35 a. *Acceptable audit risk* A measure of how willing the auditor is to accept that the financial statements may be materially misstated after the audit is completed and an unmodified opinion has been issued. This is the risk that the auditor will give an incorrect audit opinion.

Inherent risk A measure of the auditor's assessment of the susceptibility of an assertion to material misstatement before considering the effectiveness of internal control. This risk relates to the auditor's expectation of misstatements in the financial statements, ignoring internal control.

Control risk A measure of the auditor's assessment of the risk that a material misstatement could occur in an assertion and not be prevented or detected by the client's internal controls. This risk is related to the effectiveness of a client's internal controls.

9-35 (continued)

Planned detection risk A measure of the risk that audit evidence for an audit objective will fail to detect misstatements exceeding performance materiality, should such misstatements exist. In audit planning, this risk is determined by using the other three factors in the risk model using the formula $PDR = AAR / (IR \times CR)$.

b.

		Risk of Material Misstatement		
Balance-Related Audit Objectives	Acceptable Audit Risk	Inherent Risk	Control Risk	Planned Detection Risk
Existence	Medium	Medium	Medium	Medium
Completeness	Medium	Low	Medium	Medium
Accuracy	Low	High	Medium	Low
Classification	Medium	Low	Low	High
Cutoff	Medium	Medium	Low	Medium
Detail tie-in	Low	Medium	Low	Low / Medium
Realizable value	Low	High	Medium	Low
Rights and obligations	Medium	Medium	Low	Medium

- c. The accuracy and realizable value audit objectives require the greatest amount of evidence in order to reduce detection risk to a low level. The classification audit objective requires the least amount of evidence as planned detection risk is at a high level.
- d. Hopper may increase his assessment of control risk in the existence, completeness, and cutoff audit objectives, which would result in a decrease in planned detection risk. If Hopper decides it is appropriate to lower planned detection risk, he will increase the amount of audit evidence gathered.

9-36

RISK FACTOR	RELATED AUDIT RISK MODEL COMPONENT
1.	Acceptable audit risk
2.	Control risk
3.	Acceptable audit risk
4.	Inherent risk
5.	Planned detection risk
6.	Acceptable audit risk
7.	Inherent risk
8.	Inherent risk
9.	Planned detection risk
10.	Control risk

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	CONTROL RISK	INHERENT RISK	ACCEPTABLE AUDIT RISK	PLANNED EVIDENCE
a.	N	N	I	D
b.	N	N	D	I
c.	I	N	N	I
d.	I or N	I	N	I
e.	N	I	N	I
f.	N	N	I	D
g.	D	D	N or I	D
h.	I	I	N	I
i.	I	N or I	D	I
j.	I	I	D	I

■ Cases

9-38

FACTOR	EFFECT ON THE RISK OF MATERIAL MISSTATEMENT	AUDIT RISK MODEL COMPONENT
1. Henderson is a new client.	Increases	Inherent risk
2. Henderson operates in a regulated industry, which increases regulatory oversight and need for compliance with regulations.	Increases	Acceptable audit risk
3. The company's stock is publicly traded.	Increases	Acceptable audit risk
4. The company is more profitable than competitors, but recent growth has strained operations.	Increases	Acceptable audit risk
5. The company has expanded its use of derivatives and hedging transactions.	Increases	Inherent risk
6. Henderson has added competent accounting staff and has an internal audit function with direct reporting to the audit committee.	Decreases	Control risk
7. The financial statements contain several accounting estimates that are based on management assumptions.	Increases	Inherent risk
8. The company has experienced difficulty in tracking property, plant, and equipment.	Increases	Control risk
9. Henderson acquired a regional electric company.	Increases	Inherent risk
10. The audit engagement staff have experience in auditing energy and public companies.	Decreases	Planned detection risk ¹
11. Partner review of key accounts will be extensive.	Decreases	Planned detection risk. ¹

¹ The competency of the audit engagement staff and the thoroughness of the partner's review will lower the risk that material misstatements will not be detected by the auditor, which results in a lower *actual* detection risk.

9-39 Note: Excel solutions (**P939a.xls** and **P939b.xls**) are contained on the text website.

- a. See Worksheet 9-39A on pages 9-22 and 9-23. It is important to recognize that there is no *one* solution to this requirement. The determination of materiality and allocation to the accounts is *always* arbitrary. In this illustration, the auditor makes estimated adjustments for problems noted by analytical procedures. This is an important step as the potential adjustments *reduce* income before taxes, and thus materiality. The illustrated solution recognizes that with downward adjustments, actual income may be much closer to the contractual amount required for an additional contribution to the employee's pension plan. This creates a sensitivity that will need to be watched carefully as the audit progresses. The allocation to the accounts is particularly arbitrary. It is noteworthy that the sum of allocated amounts equals 1.5 times materiality for the financial statements as a whole. It is assumed that this is consistent with the audit firm's internal policies.
- b. The level of acceptable audit risk is based on an evaluation of three factors:
 1. The degree to which external users rely on the statements.
 2. The likelihood that the client will have financial difficulties after the audit report is issued.
 3. The auditor's evaluation of management's integrity.

Stanton Enterprise is a public company and therefore has a high degree of reliance by external users on its financial statements. The Company's operating results and financial condition indicate that there is very little likelihood of financial difficulty in the immediate future. With regard to management's integrity, although there has been some concern with Leonard Stanton's past bankruptcy, the carefully monitored relationship has been good for the four years Stanton has been a client. On that basis, it appears management integrity is good.

Overall, then, an acceptable audit risk level of medium would seem appropriate.

- c. See Worksheet 9-39B on pages 9-24 and 9-25 that shows both horizontal and vertical analysis of the 2015 audited and the 2016 unaudited financial statements, as well as computation of applicable ratios. Following are the key observations to be made:

Overall Results Stanton Enterprises apparently had an extremely successful year in 2016. Sales increased by 36.4

9-39 (continued)

percent, gross margin increased by 4 absolute percentage points, and income before taxes increased by 138.5 percent. Return on total assets and return on equity increased and are at admirable levels. These results allowed the Company to increase its dividends by 25 percent (recognizing that more shares were outstanding) and total stockholder's equity by 101.9 percent. Furthermore, the Company's current, quick, cash, and times interest earned ratios are up, and its debt to equity ratio is down, indicating that the Company is extremely sound from a liquidity standpoint.

Trade Accounts Receivable In the face of such growth, trade accounts receivable increased by 59.3 percent, and at the same time, accounts receivable turnover slowed and days to collect increased somewhat. However, the allowance for uncollectible accounts was only .3 percent of gross receivables at the end of 2016, down from 1.0 percent at the end of 2015. This implies that the allowance may be significantly understated for 2016 and must be looked at very carefully during the current audit. This review would include considering whether a liberalization of credit policies was used to help increase sales.

Property, Plant, and Equipment The Company made a significant additional investment in property, plant, and equipment, increasing them by 30.5 percent. These new assets will need to be verified during the current audit. It is noteworthy that accumulated depreciation increased by only 16.1 percent. This could indicate that depreciation on the new assets was not recorded, but may not, depending on dates of acquisition and depreciation method used. Depreciation must be tested considering these facts as determined.

Goodwill Goodwill also increased significantly, by \$855,000. This implies that the Company made an acquisition during the year. This could explain the increase in operating assets, and any such transaction must be examined in detail as part of the audit. Also, the goodwill from prior transactions must be considered during each audit and tested for possible impairment.

Accounts Payable Accounts payable went *down* from 2015 to 2016. This doesn't seem reasonable at all given an increase in business activity. It is very possible there are unrecorded liabilities at the end of 2016, and this must be an area of major emphasis during the audit.

9-39 (continued)

Bank Loan Payable It seems somewhat strange for the Company to have an outstanding balance on its bank loan payable at the end of 2016 given its excellent operating results. This may be attributable to the growth in accounts receivable and inventory, or could be the result of an acquisition, or they simply haven't paid it off. In any case, verifying this balance is a relatively easy audit procedure.

Federal Income Taxes Payable and Income Tax Expense The Company's effective tax rate for 2015 was 34 percent. Income tax expense is only 22.5 percent of income before taxes for 2016. Federal income taxes payable on the balance sheet is significantly lower at 12-31-16 than would be expected based on 2015. These both indicate that the Company has not made its final tax accrual for 2016, and this area will require careful attention during the audit.

Common Stock Common stock increased by 25 percent. It is possible that this occurred in connection with an acquisition (see Goodwill), or in some other way. The issuance of new shares and surrounding circumstances will need to be understood and examined.

Sales Whenever there is a drastic increase in business activity, there is an increased risk of problems. It is possible that controls will lapse or not be carefully observed. It is possible that transactions will not be carefully accounted for. Therefore, in a situation such as Stanton's it is important to understand the nature of the changes that took place and to do a careful review of controls. It will be especially important to thoroughly test cutoffs if both sales and purchase transactions.

Cost of Goods Sold and Gross Profit Consistent with the comments under sales, the auditors must determine why the gross profit percent has made such a significant improvement. Tests of costs and inventories will be more extensive than in more stable circumstances.

Pension Cost It appears that the Company exceeded the contractual amount for additional pension contribution. Yet, pension cost is a lesser percent of sales in 2016 than in 2015. This may indicate that an accrual for additional pension cost was not made. As pension cost is a complex and important area, it will be verified in detail during the audit.

9-39 (continued)

d.

	ACCEPTABLE AUDIT RISK	INHERENT RISK	SUBSTANTIVE ANALYTICAL PROCEDURES
Detail tie-in	Medium	Medium	See Note 5
Existence	Medium	Medium	See Note 5
Completeness	Medium	Medium	See Note 5
Accuracy	Medium	Medium	See Note 5
Classification	Medium	Medium	See Note 5
Cutoff	Medium	High	High
Realizable value	Medium	High	High
Rights	Medium	Medium	See Note 5
Performance materiality:			
Trade accounts receivable		\$80,000	
Allowance for uncollectible accounts		<u>15,000</u>	
Total	\$95,000		

RATIONALE

1. Acceptable audit risk is medium for the engagement; therefore, it is medium for accounts receivable and all of its related objectives.
2. Inherent risk would be considered medium for most objectives given significant changes in sales and accounts receivable.
3. Inherent risk for cutoff is considered high due to the Company's rapid growth in 2016 and the general frequency of cutoff errors.
4. Inherent risk for realizable value is considered high because of the Company's rapid growth and the amount of judgment involved in establishing the allowance for uncollectible accounts.
5. The analytical procedures performed are preliminary only, and don't provide substantive evidence. However, they can indicate areas where possible problems exist. In other words, they can't lower risk, but can increase it. In this case, they corroborate the high inherent risk level specified for cutoff and realizable value.

9-39 (continued)

Stanton Enterprises
Worksheet 9-39A
Determination of Materiality and
Allocation to the Accounts
12/31/2016

DETERMINATION OF MATERIALITY:

Income before taxes	\$8,004,277	
Possible adjustments - estimated. See Worksheet 9-39b:		
Increase allowance for uncollectible accounts	(220,000)	Increase to equal same % of trade accounts receivable as prior year.
Increase accounts payable	(1,070,000)	Reflect same increase as cost of goods sold.
Pension cost	NA	Can't estimate. May or may not be required.
Adjusted net income before taxes	<u>\$6,714,277</u>	
5 percent	<u>\$ 335,714</u>	
Round down to	<u>\$ 330,000</u>	

Note: A key consideration is whether the Company will be required to make its additional pension contribution. As more information is obtained, the amount considered material may be reduced to assure any possible misstatements in earnings are considered in light of that contractual obligation.

9-39 (continued)

Stanton Enterprises

Worksheet 9-39A, cont.

ALLOCATION TO THE ACCOUNTS:

	Prelim. 12/31/16	Performance Materiality	
Cash	\$243,689	5000	Easy to audit at low cost.
Trade accounts receivable	3,544,009	80000	Large performance materiality (PM) because account is large and requires extensive sampling to audit.
Allowance for uncollectible accounts	(120,000)	15000	Fairly large PM because of inherent risk.
Inventories	4,520,902	100000	Large PM because account is large and requires extensive sampling to audit.
Prepaid expenses	29,500	5000	Easy to audit at low cost.
Total current assets	8,218,100		
Property, plant, and equipment, at cost	12,945,255	100000	Small PM as a percent of account balance because most of balance is unchanged from prior year & audit of additions is relatively low cost.
Less: accumulated depreciation	(4,382,990)	40000	Fairly low PM due to possible risk of misstatement. See answers to part c. of HW 9-39 and worksheet 9-39B.
	8,562,265		
Goodwill	1,200,000	20000	Fairly low PM due to possible risk of misstatement. See answers to part c. of HW 9-39 and worksheet 9-39B.
Total assets	\$17,980,365		
Accounts payable	\$2,141,552	70000	Large PM because account is large and requires extensive sampling to audit.
Bank loan payable	150,000	0	Easy to audit at low cost.
Accrued liabilities	723,600	20000	Easy to audit at low cost.
Federal income taxes payable	1,200,000	40000	Fairly low PM due to possible risk of misstatement. See answers to part c. of HW 9-39 and worksheet 9-39B.
Current portion of long-term	240,000	0	Easy to audit at low cost.
Total current liabilities	4,455,152		
Long-term debt	960,000	0	Easy to audit at low cost.
Stockholders' equity:			
Common stock	1,250,000	0	Easy to audit at low cost.
Additional paid-in capital	2,469,921	0	Easy to audit at low cost.
Retained earnings	8,845,292	NA	
Total stockholders' equity	12,565,213		
Total liabilities and stockholders' equity	\$17,980,365	\$495,000	(1.5 x \$330,000)

9-39 (continued)

Stanton Enterprises
Worksheet 9-37B
Analysis of Financial Statements
and Audit Planning Worksheet
12/31/2016

BALANCE SHEET

	Preliminary 12/31/16	%	Audited 12/31/15	%	% Change
Cash	\$243,689	1.4	\$133,981	1.1	81.9
Trade accounts receivable	3,544,009	19.7	2,224,921	17.7	59.3
Allowance for uncollectible accounts	(120,000)	-0.7	(215,000)	-1.7	-44.2
Inventories	4,520,902	25.1	3,888,400	31.0	16.3
Prepaid expenses	29,500	0.2	24,700	0.2	19.4
Total current assets	8,218,100	45.7	6,057,002	48.3	35.7
Property, plant, and equipment:					
At cost	12,945,255	72.0	9,922,534	79.1	30.5
Less, accumulated depreciation	(4,382,990)	-24.4	(3,775,911)	-30.1	16.1
	8,562,265	47.6	6,146,623	49.0	39.3
Goodwill	1,200,000	6.7	345,000	2.7	247.8
	<u>\$17,980,365</u>	100.0	<u>\$12,548,625</u>	100.0	43.3
Accounts payable	\$2,141,552	11.9	\$2,526,789	20.1	-15.2
Bank loan payable	150,000	0.8	0	0.0	--
Accrued liabilities	723,600	4.0	598,020	4.8	21.0
Federal income taxes payable	1,200,000	6.7	1,759,000	14.0	-31.8
Current portion of long-term debt	240,000	1.3	240,000	1.9	0.0
Total current liabilities	4,455,152	24.8	5,123,809	40.8	-13.0
Long-term debt	960,000	5.3	1,200,000	9.6	-20.0
Stockholder's equity:					
Common stock	1,250,000	7.0	1,000,000	8.0	25.0
Additional paid-in capital	2,469,921	13.7	1,333,801	10.6	85.2
Retained earnings	8,845,292	49.2	3,891,015	31.0	127.3
	<u>12,565,213</u>	69.9	<u>6,224,816</u>	49.6	101.9
	<u>\$17,980,365</u>	100.0	<u>\$12,548,625</u>	100.0	43.3

9-39 (continued)

Stanton Enterprises
Worksheet 9-39B, cont.
COMBINED STATEMENT OF INCOME
AND RETAINED EARNINGS

	Preliminary 12/31/16	%	Audited 12/31/15	%	% Change
Sales	\$43,994,931	100.0	\$32,258,015	100.0	36.4
Cost of goods sold	<u>24,197,212</u>	55.0	<u>19,032,229</u>	59.0	27.1
Gross profit	19,797,719	45.0	13,225,786	41.0	49.7
Selling, general, and administrative expenses	10,592,221	24.1	8,900,432	27.6	19.0
Pension cost	1,117,845	2.5	865,030	2.7	29.2
Interest cost	<u>83,376</u>	0.2	<u>104,220</u>	0.3	-20.0
	<u>11,793,442</u>	26.8	<u>9,869,682</u>	30.6	19.5
Income before taxes	8,004,277	18.2	3,356,104	10.4	138.5
Income tax expense	<u>1,800,000</u>	4.1	<u>1,141,000</u>	3.5	57.8
Net income	6,204,277	14.1	2,215,104	6.9	180.1
Beginning retained earnings	<u>3,891,015</u>		<u>2,675,911</u>		
	10,095,292		4,891,015		
Dividends declared	<u>(1,250,000)</u>		<u>(1,000,000)</u>		
Ending retained earnings	<u><u>\$8,845,292</u></u>		<u><u>\$3,891,015</u></u>		

SIGNIFICANT RATIOS

Current ratio	1.84	1.18
Quick ratio	0.82	0.42
Cash ratio	0.05	0.03
Accounts receivable turnover	12.41	14.50
Days to collect	29.40	25.18
Inventory turnover	5.35	4.89
Days to sell	68.20	74.57
Days to convert to cash	97.60	99.75
Debt to equity ratio	0.43	1.02
Tangible net assets to equity	1.34	1.96
Times interest earned	97.00	33.20
Efficiency ratio	2.62	2.64
Profit margin ratio	0.18	0.11
Profitability ratio	0.48	0.28
Return on total assets	0.45	0.27
Return on equity	0.64	0.54

Note: Some ratios are based on
year-end balances, as 12-31-14
balances are not provided.

■ Integrated Case Application

9-40

PINNACLE MANUFACTURING—PART II

- a. Acceptable Audit Risk and Engagement Risk Issues:

External users' reliance on financial statements:

1. The company is privately held, but there is a large amount of debt; therefore, the financial statements will be used fairly extensively. Also, management is considering selling the Machine-Tech division, which has the potential to result in extensive use of the statements by the buyers.
2. Item 6 in the planning phase indicates plans for additional debt financing.

Likelihood of financial difficulties:

1. The solar power engine business revolves around constantly changing technology, thus making it inherently more risky than other businesses, with a better chance of subsequent bankruptcy. Item 1 in the planning issues raises a concern about the viability of the Solar-Electro division, but not necessarily the entire company.
2. The conclusion in Part I of the case was that the likelihood of financial failure is low, even considering the issue with Solar-Electro.
3. Item 9 in the planning phase indicates there is a debt covenant requiring a current ratio above 2.0 and a debt-to-equity ratio below 1.0. The current ratio has fallen below 2.0. This could result in the loan being called unless a waiver of the loan covenant is granted.

Management integrity:

No major issue exists that would cause the auditor to question management integrity, but the auditor should have done extensive client acceptance procedures before accepting the client. It is possible that Item 8 in the planning phase, turnover of internal audit personnel, could be intentional and increases the risk of fraudulent financial reporting.

- b. Acceptable audit risk is likely to be medium to low because of the factors listed previously, especially the planned increase in financing and the potential violation of the debt covenant agreement. Some might prefer an even lower acceptable risk because it is a first year audit.

9-40 (continued)

- c. Inherent risks are addressed by examining each of the 11 items in the planning phase.
1. **Inherent Risk:** No effect on inherent risk.
 2. **Inherent Risk:** The primary concern is the possibility of obsolete inventory, which affects the valuation of inventory at the lower of cost or market.
Accounts Affected: Inventory, cost of goods sold
 3. **Inherent Risk:** There is a potential related party transaction, which could affect the valuation of the transaction and may require disclosure as a related party transaction.
Accounts Affected: Manufacturing equipment, footnote
 4. **Inherent Risk:** This situation involves a nonroutine transaction where there is a risk that materials, labor and/or overhead are incorrectly applied to the property accounts.
Accounts Affected: Property accounts, inventory, and cost of sales
 5. **Inherent Risk:** A receivable outstanding for several months from a customer making up 15% of the company's outstanding accounts receivable balance may indicate a major collection problem, which could result in an understatement of the allowance for uncollectible accounts.
Accounts Affected: Accounts receivable, bad debt expense, allowance for uncollectible accounts
 6. **Inherent risk:** No effect on inherent risk.
 7. **Inherent Risk:** There is a potential related party transaction, which could affect the valuation of the transaction and may require disclosure as a related party transaction.
Accounts Affected: Repairs and maintenance expense and accounts payable
 8. **Inherent Risk:** Although this does not directly affect inherent risk, it is possible that turnover of internal audit personnel could be intentional and increases the risk of fraudulent financial reporting. The turnover may also affect the auditor's assessment of control risk.
Accounts Affected: All accounts

9-40 (continued)

9. **Inherent Risk:** In addition to affecting acceptable audit risk, the auditor should be concerned about the risk of fraudulent financial reporting due to the incentive to make certain that all debt covenants have been met.
Accounts Affected: All accounts
10. **Inherent Risk:** An ongoing dispute with the Internal Revenue Service may require an adjustment to income tax liability or a disclosure in footnotes for a contingency, depending on the status of the dispute.
Accounts Affected: Income tax expense and income taxes payable
11. **Inherent Risk:** This situation involves a related party transaction (Solar-Electro borrowed money from the Welburn division). Because this transaction was not conducted with an outside party, it is possible that the related receivable and payable might not have been properly eliminated on Pinnacle's consolidated financial statements.
Accounts Affected: Notes payable, notes receivable, interest expense and interest income