Third Edition

# PRINCIPLES OF AUDITING

## An Introduction to International Standards on Auditing

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# PRINCIPLES OF AUDITING

**Business Risk and Significant Risk – Lehman Brothers and Ernst & Young (continued)**

In a press release, Ernst & Young stated: 'Lehman's bankruptcy occurred in the midst of a global financial crisis triggered by dramatic increases in mortgage defaults, associated losses in mortgage and real estate portfolios, and a severe tightening of liquidity. Lehman's bankruptcy was preceded and followed by other bankruptcies, distressed mergers, restructurings, and government bailouts of all of the other major investment banks, as well as other major financial institutions. In short, Lehman's bankruptcy was not caused by any accounting issues.'

**Discussion Questions**

- Do you believe it is possible that Lehman Brothers was able to borrow more money thanks to the use of repo 105 transactions?
- Did Ernst & Young put too much emphasis on the form of repo 105 transactions and neglected the substance of repo 105 transactions?
- Do you blame Lehman Brothers for trying almost anything to avoid bankruptcy?

**References**

Brunnermeier, M.K. (2008), 'Deciphering the Liquidity and Credit Crunch 2007–08', NBER Working Paper No. 14612, National Bureau of Economic Research, Cambridge, MA.
http://en.wikipedia.org/wiki/Lehman_Brothers.
http://www.accountingweb.com/topic/accounting-auditing/did-ernst-young-really-assist-financial-fraud.

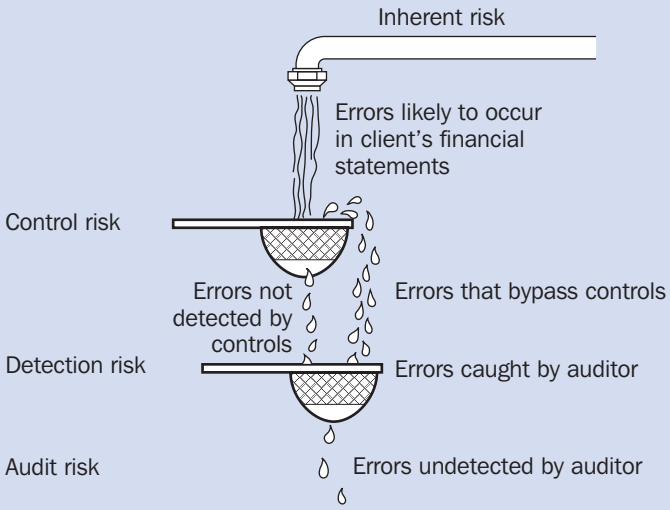
Illustration 6.11 shows a symbolic graphic used by AICPA to illustrate how audit risk works. The potential pool of material errors is represented by the *tap*[20] at the top of the illustration. The *sieves*[21] represent the means by which the client and the auditor attempt to remove material errors from the financial statements. In Illustration 6.11,[22] the first sieve represents the internal control system. The client may install a system of internal accounting control to detect material errors and correct them. Ideally, the control system should detect any material errors before they enter the financial statements. However, there is some risk that errors will either pass undetected through the control system (perhaps as a result of a breakdown or weakness) or will bypass the control system altogether (e.g. where there are no controls in place such as an unusual exchange of non-monetary assets). The liquid falling through the sieve represents the errors not detected and the spillover represents those errors that bypass the control system. If the internal control system does not detect and correct the errors, they will be included in the financial statements. The auditor must design audit procedures that will provide reasonable assurance that material errors will be detected and removed from the financial statements. In Illustration 6.11, the second sieve represents the auditor's procedures. Despite internal controls and auditors' procedures to detect misstatement, there will always be the possibility that some misstatements will be undetected. This is audit risk.

Illustrations 6.12 and 6.13 show the relationship between inherent, control and detection risks.

There is an inverse relationship between detection risk and the combined level of inherent and control risks. For example, when inherent and control risks are high, acceptable levels of detection risk need to be low to reduce audit risk to an acceptably low

**ILLUSTRATION 6.11**

## Components of Audit Risk




Source: AICPA, 'Auditing Procedures Study' in *Audits of Small Business*, AICPA, New York, 1985, p. 44, reproduced in Dan M. Guy, C. Wayne Alderman and Alan J. Winters, *Auditing*, Harcourt Brace Jovanovich, San Diego, California, 1996, p. 131.

**ILLUSTRATION 6.12**

## Interrelationship of the Components of Audit Risk

The following table shows how the acceptable level of detection risk may vary based on assessments of inherent and control risks, based on the Appendix to International Standard on Auditing 400.

| | | **Auditor's assessment of control risk** | | |
|---|---|---|---|---|
| | | High | Medium | Low |
| **Auditor's assessment of inherent risk** | High | Lowest | Lower | Medium |
| | Medium | Lower | Medium | Higher |
| | Low | Medium | Higher | Highest |

The darker shaded areas in this table relate to detection risk.
There is an inverse relationship between detection risk and the combined level of inherent and control risks. For example, when inherent and control risks are high, acceptable levels of detection risk need to be low to reduce audit risk to an acceptably low level. On the other hand, when inherent and control risks are low, an auditor can accept a higher detection risk and still reduce audit risk to an acceptably low level.

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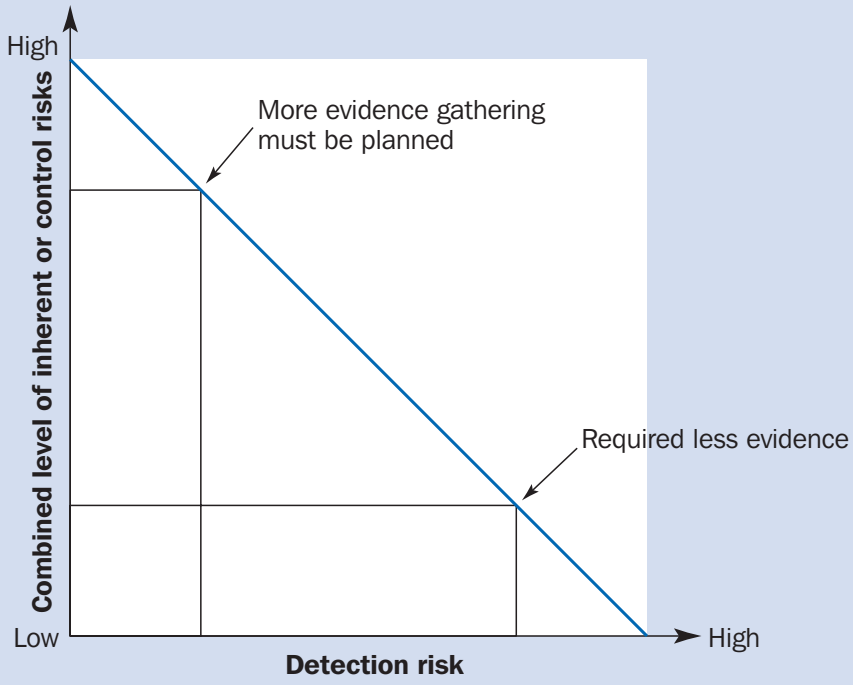
ILLUSTRATION 6.13

**Relationship between Inherent, Control and Detection Risk**




## Significant Risks

**Significant risks** are audit risks that require special audit consideration. Significant risks generally relate to judgemental matters and significant non-routine transactions. Judgement is used, for example, in the development of significant accounting or **fair value** estimates. Non-routine transactions are transactions that are unusual, either due to size or nature, and that therefore occur infrequently. Risks of material misstatement may be greater for significant judgmental matters requiring accounting estimates or revenue recognition and for assumptions about the effects of future events (e.g. fair value) than for ordinary transactions.

Significant non-routine transactions may arise from management intervention in specifying the accounting treatment for a transaction, manual intervention for data collection and processing, complex calculations or accounting principles, transactions for which there is difficulty in implementing effective controls, and significant related party transactions. These risks are less likely to be subjected to routine control systems and so a more in-depth understanding helps the auditor develop an effective audit approach.

### Special Audit Consideration

As part of risk assessment, the auditor may determine some of the risks identified are significant risks that require special audit consideration. Classification of a risk as requiring special consideration is important in the context of the auditor's response

to the risk (see Chapter 7 'Internal Control and Control Risk'). In particular, it is even more important for significant than for non-significant risks that the auditor evaluates the design of the entity's controls, including relevant control procedures, and obtains contemporaneous evidence as to whether or not they have been implemented. Further, it is required that the auditor performs substantive procedures that are specifically responsive to the risks.

### Is the Risk Significant?

Significant risks arise on most audits, but their determination is a matter for the auditor's professional judgement. In determining what a significant risk is the auditor considers a number of matters, including the following:[23]

- Whether the risk is a risk of fraud.
- The likelihood of the occurrence of the risk.
- Whether the risk is related to recent significant economic, accounting, or other developments and, therefore, requires specific attention.
- The complexity of transactions that may give rise to the risk.
- Whether the risk involves significant transactions with related parties.
- The degree of subjectivity in the measurement of financial information related to the risk.
- Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment.

## 6.5 Materiality

Materiality is not specifically defined in the ISAs. ISA 320, instead, defines materiality in the context of an audit and as performance materiality. Although financial reporting frameworks may discuss materiality in different terms, in the context of an audit, they generally explain that:

1 Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.
2 Judgements about materiality are made in light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both.
3 Judgements about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.[24]

**Performance materiality** means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole. This reduces to an appropriately low level the probability that the total of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amounts set by the auditor at less than the materiality levels for particular classes of transactions, account balances or disclosures.[25]

The auditor's responsibility is to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with financial accounting standards. Materiality is the degree of inaccuracy or imprecision that is still considered acceptable given the purpose of the financial statements.[26]

## Materiality Level

Planning materiality is a concept that is used to design the audit such that the auditor can obtain reasonable assurance that any error of a relevant (material) size or nature will be identified. There are additional costs for an auditor to audit with a lower materiality. The lower the materiality, the more costly is the audit. If any error of whatever small size needs to be found in the audit, the auditor would spend significantly more time than when a certain level of imprecision (higher materiality level) is considered acceptable.

What is material is often difficult to determine in practice. However, four factors are generally considered: size of item; nature of item; the circumstances; and the cost and benefit of auditing the item.

## Size of the Item

The most common application of materiality concerns the *size of the item* considered. A large dollar amount item omitted from the financial statements is generally material. Size must be considered in relative terms, for example as a percentage of the relevant base (net income, total assets, sales, etc.) rather than an absolute amount. The view that size is an essential determinant of materiality means that, for financial reporting purposes, materiality can only be judged in relation to items or errors which are quantifiable in monetary terms.

## Nature of the Item

The *nature of an item* is a qualitative characteristic. An auditor cannot quantify the materiality decision in all cases; certain items may have significance even though the dollar amount may not be quite as large as the auditor would typically consider material. For example, a political bribe by an auditee, even though immaterial in size, may nevertheless be of such a sensitive nature and have such an effect on the company financial statement that users would need to be told. It has been suggested[27] that in making judgements about materiality, the following aspects of the nature of a misstatement should be considered:

- the events or transactions giving rise to the misstatement;
- the legality, sensitivity, normality and potential circumstances of the event or transaction;
- the identity of any other parties involved; and
- the accounts and disclosure notes affected.

## Circumstances of Occurrence

The materiality of an error depends upon the *circumstances of its occurrence*. There are two types of relevant circumstances:

1 the users of the accounting information's economic decision-making process;
2 the context of the accounting information in which an item or error occurs.

Since materiality means the impact on the decisions of the user, the auditor must have knowledge of the likely users of the financial statements and those users' decisions process. If a company is being audited prior to listing on a national stock exchange or a large loan or merger, the users will be of one type. If statements of a closely held partnership are being audited, users will be of a different type.

For example, if the primary users of the financial statements are creditors, the auditor may assign a low materiality threshold to those items on financial statements that affect **liquidity**[28] such as current assets and current liabilities. On the other hand, if the primary users are investors or potential investors, the auditor may assign a low materiality threshold to income.

## Reliability, Precision and Amount of Evidence

The auditor should consider materiality and its relationship with audit risk when conducting an audit, according to ISA 320.[29] What does this mean? In statistical sampling, there is a fixed relationship between:

- the reliability of an assertion based on the sampling (in auditing this is determined by audit risk);
- the precision of this statement (in auditing it is determined by materiality);
- the amount of evidence that should be gathered in order to make this assertion.

Changes in one of these three items have implications for (one of) the other two.

### Example: Three Assumptions in the Same Circumstance

A real-life example might illustrate this relationship between reliability, precision and amount of evidence. Suppose you are asked to make an assertion about the average taxable income of randomly selected people, shopping at the Kurfürstendamm in Berlin. Also suppose that gathering information regarding the taxable income of these people is costly. Consider the following three situations:

1 You are asked to make, with a high degree of reliability (you were asked to bet quite some money on the correctness of your assertion), the assertion that the average annual taxable income of ten people will be between minus and plus €300,000,000. Even though a high degree of reliability is requested (i.e. a lot is at stake for you), you will probably do little or no investigative work because you were allowed to make a very imprecise statement (i.e. a very high level of tolerance is allowed).
2 You are asked to make, with a low degree of reliability (you were asked to bet only a symbolic €1 on the correctness of your assertion), the assertion that the average annual taxable income of these random ten people will be between €0 and €70,000. Even though this time a high degree of precision is requested, you will probably only do little or no (costly) investigative work, since you were only asked to make your assertion with a low degree of reliability (not a lot at stake for you).
3 You are asked to make, with a high degree of reliability (again, you were asked to bet quite some money on the correctness of your assertion), the assertion that the average annual taxable income of these ten people will be between €0 and €70,000. Because of the high degree of reliability and precision requested (i.e. a lot is at stake for you and only a relatively low degree of tolerance is accepted in your statement), you will probably do extensive investigative work.