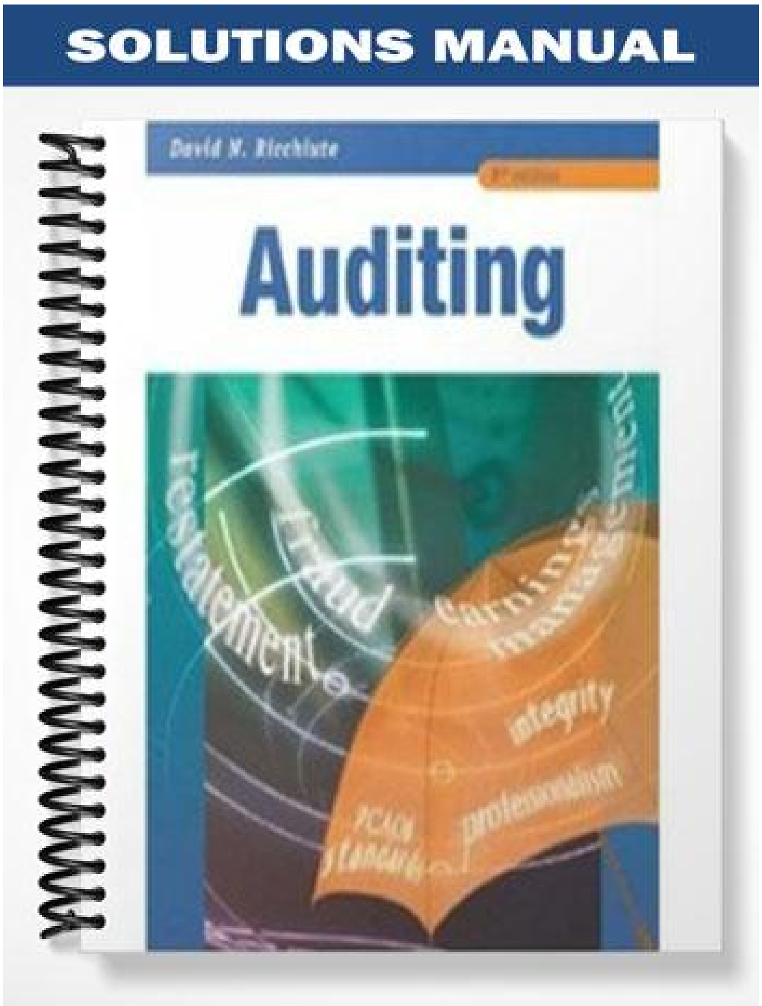
SOLUTIONS MANUAL
David N. Ricchiute
Auditing
restatement
fraud
earnings management
integrity
professionalism
PCAOB standards

Chapter 2

Standards, Materiality, and Risk

QUESTIONS

1. ..By *standards*, the AICPA means generally accepted auditing standards (GAAS) and *Statements on Auditing Standards (SASs).* By *interpretive publications*, the AICPA means
   a) Auditing Standards Board "Interpretations,"
   b) Appendixes of the SASs,
   c) Auditing guidance within AICPA Audit & Accounting Guides, and
   d) AICPA auditing Statements of Position.

2. Following is an outline of significant events leading to development of the eleven *attestation standards* and the ten *generally accepted auditing standards*:
   a) February 1941: SEC issued *ASR No. 21*, which required that auditors state within their audit report whether the audit was conducted in accordance with *GAAS*. Because there were no written standards, the AICPA's Committee on Auditing Procedure (CAP) began developing standards.
   b) October 1947: The CAP finalized nine standards. World War II hampered progress in developing standards, thus accounting for the long period between *ASR No. 21* and the completion of the original nine standards.
   c) 1948: The nine standards were approved by AICPA member vote. A tenth was adopted the following year in SAP No.23.
   d) 1986: The Auditing Standards Board and the Accounting and Review Services Committee jointly develop the eleven *attestation standards*.
   e) 1988: *GAAS*□ second field work standard and second reporting standard were revised by *SAS No. 55* and *SAS No. 58*, respectively.

3. *SAS No. 95*, "Generally Accepted Auditing Standards," in 2001and *SAS No. 98*, "Omnibus SAS," clarifies that standards refers both to GAAS and to *SASs,* and interpretive publications refers to "recommendations on the application of SASs" the Auditing Standards Board issues formally under the title "Interpretations," to appendixes of the SASs, to auditing guidance within AICPA Audit & Accounting Guides, and to AICPA auditing Statements of Position.

4. . Under the authority the *Sarbanes-Oxley Act*, the SEC in January 2003 announced rules that addressed, among other things, auditor rotation, client's employing former auditors, audit partner compensation plans, and reporting to a client's audit committee. The rules:

   a) Require that an engagement partner rotate after no more than five or seven consecutive years, depending on the partner's involvement in the audit,
   b) Establish rules that an accounting firm would not be independent of a client that employs one of the client's former auditors within the one-year period preceding the audit,
   c) Establish rules that an auditor is not independent of a client if her or she earned compensation based on selling to the client a service other than an audit, review or other attest service, and
   d) Require that an auditor report certain matters, including "critical" accounting policies, to the client's audit committee.

5. Engagement-team independence holds only the engagement team accountable for the rules of independence. Firm-wide independence holds all firm members accountable, even those not assigned to the engagement.

6. Mautz and Sharaf offered several thoughts regarding “precautions” that should be exercised by “prudent practitioners”:
   a) Obtain knowledge about foreseeable risk.
   b) Give attention to foreseeable risk.
   c) Consider unusual circumstances or relationships when planning or performing an engagement.
   d) Recognize unfamiliar situations and take precautionary measures.
   e) Take steps to resolve doubtful impressions or unanswered questions.
   f) Keep current of developments in areas of competence.
   g) Review the work of assistants.

7. To broaden their reach, WorldCom paid so-called “line costs” to access third-party telecommunication companies’ transmission lines. Rather than charge the line costs to income, thereby reducing net income, WorldCom capitalized the costs in amounts sufficient to report earnings consistent with analysts’ expectations. The judge’s settlement ruling reported that the misstatement overstated net income by an estimated $11 billion.

8. Under *Statement on Auditing Standards No. 31*, “Evidential Matter” (AU Sec. 330), audit evidence means the underlying accounting data and all related corroborating information available to an auditor:

   a) *Underlying accounting data* includes journals, ledgers, reconciliations, and accounting manuals, and
   b) *Corroborating information* includes receiving reports, invoices, contracts, and representations from third parties, such as confirmations of receivables balances with debtors

9. *Sufficient* refers to the quantity of audit evidence obtained, although audit decisions must be reached within a reasonable length of time and at reasonable cost, requiring that an auditor balance the cost of obtaining additional evidence with the usefulness of the evidence obtained. In turn, *competent* refers to the validity and relevance of evidence, both of which depend heavily on whether the evidence is obtained from independent sources, obtained directly by the auditor, or processed through reliable information systems.

10. In a so-called *procedures-driven* audits, attributed by some to audits done decades ago, an auditor applies roughly the same audit procedures on all audit engagements and attempts to reap efficiencies by learning to perform the procedures more quickly over the years. In contrast, in a so-called *risk-driven* audit, an allocates proportionately more effort to the assertions, accounts, and disclosures that he or she judges the most risky, since low-risk accounts or disclosures are not likely worthy of significant effort.

11. Sunbeam management manipulated earnings by:
    a) Inflating a restructuring accrual in the fourth quarter of 1996, and bleeding the excess into 1997 earnings,
    b) Recording bill & hold sales in the fourth quarter of 1997 that the Sunbeam, not the buyers, requested.

12. Audit risk is the likelihood that an auditor may unknowingly fail to modify an opinion on misstated financial statements. In contrast, business risk is the likelihood that an auditor may incur damages despite having issued the appropriate audit report.

13. During an engagement an auditor considers materiality at least twice: once while planning the engagement, and again after all audit procedures have been completed. When planning, the auditor determines a *preliminary estimate of materiality* for the entire set of financial statements taken as a whole. The preliminary estimate is the maximum amount by which a set of financial statements could be misstated and still not cause the auditor to believe that the decisions of reasonable users would be affected.

    Toward the end of an engagement, after all audit evidence has been gathered and evaluated, an auditor again considers materiality by comparing the combined misstatement for all accounts with the preliminary (or revised) estimate for the entire set of financial statements taken as a whole. If the combined misstatement exceeds the preliminary estimate, then the financial statements would be materially misstated, and the auditor could either perform additional audit procedures or request that management adjust the misstated accounts.

14. In *TSC Industries v. Northway, Inc.*, the U.S. Supreme Court ruled that a fact is material "if there is a substantial likelihood that the ... fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." That is, relying solely on quantitative criteria may deprived an investor of the "total mix" of information relevant to his or her investment decision.

15. Empirical research has revealed the following frequently used criteria:
    a) Percentage effect on net income.
    b) Percentage effect on total revenues.
    c) Percentage effect on total assets.

16. Qualitative materiality criteria include whether a misstatement:

    Affects compliance with loan covenants or other contractual requirements
    Masks a change in earnings or other trends
    Conceals an unlawful transaction, such as a violation of the *Foreign Corrupt Practices Act*
    Prompts undue expectations about the future.
    Hides a failure to meet analysts's consensus expectations
    Arises from an item capable of precise measurement or from an estimate
    Affects management's compensation

17. The chapter describes three approaches for allocating the preliminary estimate of materiality to individual financial statement accounts:
    a) Relative magnitude of financial statement accounts.
    b) Relative variability of financial statement accounts.
    c) Professional judgment alone.

18. The three component risks underlying audit risk for an individual financial statement account are:
    a) *Inherent risk*: The susceptibility of an account balance to error, assuming there are no related control procedures.
    b) *Control risk*: The risk that error could occur and will not be prevented or detected by the internal controls, particularly the client's control activities.

c) *Detection risk*: The risk that error could occur and will not be detected by the auditor's procedures.

19. Issued by the SEC, and applicable to audits of public companies, *SAB No. 99,* "Materiality," establishes that an auditor should not rely solely on quantitative materiality criteria, should judge the materiality of misstatements both individually and in the aggregate, and should treat as inappropriate (if not unlawful) immaterial misstatements that are intentional.

20. An auditor would likely have a relatively higher materiality threshold, since the auditor focuses at the level of the financial statements taken as a whole and management focuses at the account balance level. For example, a relatively small and unintentional error in general & administrative expenses may be quite immaterial to the financial statements but, on the other hand, may have an effect on management's calculation of an administrative employee's annual bonus.

MULTIPLE CHOICE

1.	b	6.	c	11.	d	16.	a
2.	b	7.	b	12.	a	17.	c
3.	a	8.	d	13.	a	18.	d
4.	c	9.	b	14.	b	19.	a
5.	b	10.	c	15.	d	20.	c

PROBLEMS AND DISCUSSION CASES

PROBLEM 2-1

Unmatched Attestation Standard

2nd General: adequate knowledge	Implicitly captured within 1st *GAAS* general standard, since knowledge relates to generally accepted accounting principles on all financial statement audits but may vary from attestation engagement to attestation engagement.
3rd General: assertion capable of evaluation against reason-able criteria	All financial statement assertions are well known (Chapter 6: *SAS No. 31: existence or occurrence, completeness, rights and obligations, valuation or allocation, presentation and disclosure*) and the evaluation criteria are well known: GAAP.
1st Reporting: identify	As above, all five financial assertion statement assertions are well known.
4th Reporting: statement limiting report□s use	Audit reports for publicly traded companies are publicly available

Unmatched GAAS

2nd Fieldwork: internal control	Internal control is irrelevant to attestation engagements, unless the engagement is to attest to assertions about internal control. In financial statement audits, internal control is considered as a basis to reduce the extent of substantive tests.
3rd Reporting: disclosure	Financial statement disclosures are irrelevant to attestation

	engagements, but are largely what financial statement audits are about.
4th Reporting: opinion	Opinions about financial statements are irrelevant to attestation engagements.

PROBLEM 2-2
I've found this problem to be effective as an in-class, quick-case approached as follows:

Approach:
- Project case on screen
- Ask one student to read the case aloud.
- Assign students to 2-person discussion groups.
- Allow 5 minutes for in-group discussion (unaided by the instructor).
- Assuming the role of the CFO, facilitate 10 minutes of class discussion.

Key Point:
Although intended originally as "a first step in the development of realistic and useful standards for the profession" (Mautz and Sharaf, *The Philosophy of Auditing*, 1961, p. 112), GAAS have withstood the test of time, largely because the standards are sufficiently broad to capture a changing audit environment. Auditing *standards* are the guidelines or measures of quality for a financial statement audit. Auditing *procedures*, in contrast, are the means an independent auditor uses to discharge his or her responsibilities under auditing standards and, as a result, change as the audit environment changes.

PROBLEM 2-3
1. Auditing standards deal with measures of the quality with which auditing procedures are performed and with the objectives of the procedures. The standards are concerned with the auditor's professional qualities and the judgments exercised in the performance of an audit. Auditing procedures are the specific acts carried out by an auditor in obtaining sufficient evidential matter for an opinion. The acts include such things as testing cash and verifying additions to assets.

2. There are often a variety of accounting methods to reflect a particular set of circumstances. Not all methods would reflect the situation properly in financial statements. The alternative methods that will reflect the situation properly would be included among "generally accepted accounting principles." This phrase in the auditor's opinion assures the financial statement user that the accounting principles used in the preparation of the statements are among those that the accounting profession feels will properly reflect the activities of the company audited.

PROBLEM 2-4
1. Although the first general standard effectively precludes an auditor from accepting engagements for which she or he is not proficient, it does not preclude an auditor from improving skills in order to accept engagements. The nature and extent of Farell's professional development course certainly contributed to her proficiency in computer audits. However, the key question becomes: "Is Farell being intellectually honest with herself by concluding that the course has prepared her to conduct an EDP audit?" Given the wording of the question, there really is no reason to doubt Farell's proficiency.

2. Farell should participate in computer training for a variety of reasons, including:
   a) To be independent, Farell must be capable of making her own audit judgments. If she lacks proficiency in computer systems, Farell could find herself relying dangerously upon client

personnel to make audit judgments.

b) By accepting the Whitely engagement, Farell effectively holds herself out as possessing the knowledge and skills to audit financial statements generated by a computer. Thus, Farell must be capable of using audit procedures designed for computer audits.

c) Lacking sufficient training, Farell would be incapable of properly supervising audit assistants and evaluating their work.

PROBLEM 2-5

The auditor expresses an opinion on whether a company's statements present fairly the financial position, results of operations, and cash flows. An unqualified opinion gives assurance to users that the statements are presented fairly. Independence is an important ingredient to the acceptance of an auditor's opinion as sound evidence of fairly presented statements.

Independence may be difficult to achieve, for example, if the fees from a particular engagement represent a material portion of an auditor's income. If an auditor had a financial interest in a client prior to the client-professional relationship (the auditor would be required to divest himself or herself of this interest), independence might be difficult to develop. The performance of nonaudit services might also interfere with an auditor's ability to maintain the proper independent attitude. Independence is a state of mind. Such a state of mind is necessary for the auditor to function without being subject to pressures to compromise his or her work. An auditor must appear to be independent as well as be independent. The items listed in the prior paragraph may not in fact impair independence, but they may give others cause to question it. The auditor must be on guard at all times to maintain independence in both fact and appearance.

PROBLEM 2-6

Note: The purpose of this problem is to encourage students to consider the relationship between the content of a standard scope paragraph and the general and field standards. The scope paragraph states specifically that the audit was conducted in accordance with GAAS; therefore, the paragraph implies:

a) An audit was performed by a person or persons having adequate technical training and proficiency in auditing.

b) An independence in mental attitude was maintained by the auditor(s).

c) Due professional care was exercised in the performance of the audit and preparation of the reports. Of course, these statements are merely the general standards stated in the past tense. The scope paragraph also implies:
    a) The work was adequately planned, and assistants, if any, were properly supervised.
    b) A sufficient understanding of the internal controls was obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.
    c) Sufficient competent evidential matter was obtained through inspection, observation, inquiry, and confirmation to afford a reasonable basis for an opinion regarding the financial statements audited.

These statements, of course, represent the field work standards stated in the past tense.

PROBLEM 2-7

1. In accordance with the first standard of field work, an auditor should be appointed before or soon after the year under audit begins. Thus, it would have been preferable for Berke & Co. to accept the Barbizon engagement in 2004 or early 2005. Early appointment would have allowed Berke & Co. to

plan an expeditious audit and consider completing some audit work before December 31, 2004, the last day of the fiscal year. However, even though the fiscal year to be audited has ended, Berke & Co. can accept the engagement if:

a) an adequate audit can be conducted, and
b) Barbizon is alerted that an unqualified opinion may not necessarily be issued.

Of course, this second condition could preclude Farmers Loan & Trust from granting the $125,000 loan. Berke & Co. could accept the engagement only if there was reason to believe that an audit could be conducted in accordance with generally accepted auditing standards.

2. Accounts receivable could be confirmed and physical inventory observed soon after the engagement is accepted, and the activity in these accounts (e.g., sales, purchases, cash receipts) reconciled back to December 31, 2004. However, this could only be done if internal controls could be relied upon. In addition, other audit procedures could be applied, such as reviewing cash receipts records to determine if December 31, 2004, receivables were subsequently collected.

PROBLEM 2-8

1. The books of original entry, general and subsidiary ledgers, related accounting manuals, and less formal accounting records such as work sheets are the primary sources of evidence supporting the financial statements. The auditor tests these data by analysis and review, by retracing the procedural steps followed in the accounting process and in developing the work sheets, by recalculation, and by reconciling related types and applications of the same information.

   While the underlying accounting data are absolutely necessary to form an opinion on the financial statements, these records do not provide sufficient support. The auditor must also gather and examine corroborating evidence to support the underlying accounting data and representations in the financial statements. This corroborating evidence includes documentary material such as checks, invoices, contracts, and minutes of meetings; confirmations and other written representations by knowledgeable people; information obtained by the auditor by inquiry, observation, inspection, and physical examination; and other information developed by, or available to, the auditor which permits her or him to reach conclusions through valid reasoning.

   In determining how to gather sufficient competent evidential matter, the auditor might consider using statistical sampling techniques, which have been found to be advantageous in certain instances. The use of statistical sampling, however, does not reduce the need for judgment by the auditor.

2. To be of any value in forming an opinion on the financial statements, the evidence must be competent, i.e., valid and relevant. The validity of audit evidence depends primarily upon the circumstances under which it is obtained. In general, the following presumptions can be made about the validity of evidential matter.
   a) Evidential matter obtained from independent sources outside an enterprise provides greater assurance of reliability than that which is secured solely within the enterprise.
   b) Accounting data and financial statements developed under satisfactory internal controls are more reliable than those which are developed under unsatisfactory conditions.
   c) Direct personal knowledge obtained by the independent auditor through physical examination, observation, computation, and inspection is more persuasive than information obtained indirectly.

PROBLEM 2-9

1. The senior accountant who preceded you violated the generally accepted auditing fieldwork

standards, which provide that (a) the work is to be adequately planned, and assistants, if any, are to be properly supervised and (b) a sufficient understanding of internal control should be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.

The work was not adequately planned. As evidenced by the working papers, certain audit procedures that should have been performed early were not done during the first half of the engagement. Conversely, other audit procedures were performed prematurely either because their approach depended on information not yet derived or because they deserved less timing priority than other work not yet commenced.

The junior accountant on the Carter engagement was inexperienced and required more than an ordinary degree of supervision by the senior accountant. Proper supervision always requires giving continued attention to the assistant. The senior accountant must give adequate instructions to the assistant prior to commencing the work, oversee the work as it is being performed, provide guidance where necessary, and make a critical review and offer constructive suggestions concerning the work as soon as practicable after it has been completed. There is much evidence of a lack of supervision and review on the Carter engagement, such as the poor condition of the assistant's working papers and the absence of a reviewer's signature on the papers.

The working papers show that a sufficient understanding of internal control was not obtained, although other work was done in many areas, including the tests of transactions, the scope of which should bear a relationship to the findings for internal control. Should the subsequent consideration of controls in effect at Carter reveal unanticipated weaknesses, audit work in the related areas must be extended. Should the controls prove stronger than anticipated, too much work would have been performed, and the result would be either a higher audit fee to the client or an absorption of the excess cost by the accounting firm, or possibly a combination of both.

2. a) The work that requires early attention is as follows:
    1. Trade accounts receivable: First request for confirmation should be mailed immediately because of the time required to process the replies, mail second requests, and follow up exceptions and accounts from which no reply was received.
    2. Minutes: Any important information concerning the Company's plans and operations should be obtained early by reading the minutes.
    3. Internal control: Results are needed early because they will determine the scope of other audit tests.
    4. Analytic review of operations: This work will reveal abnormal fluctuations of income and expense and explanations therefore and may have a bearing on the particular periods to be selected for testing.
    5. Supervision and review: A prompt review of completed papers is required. Additional work will probably be needed on the work done previously.

   b) Tax returns, letters relating to control structure deficiencies, and procedural recommendations for management are usually not required simultaneously with the auditor's report. It should be possible to postpone the preparation of these items and also any work done exclusively to develop information for them. Often special work is done at the client's request, although it is not considered essential for audit purposes. Any such work could be postponed if it did not create a conflict in the client's timing requirements.

PROBLEM 2-10

1. An auditor has the responsibility for protecting the readers of a client's annual reports from being unknowingly or intentionally misled by financial statements that are not comparable to those of prior

years. The second standard of reporting requires the auditor's report identify those circumstances in which generally accepted accounting principles have not been observed consistently in the current period in relation to the preceding period. The chief objective of this requirement is to give assurance that the comparability of financial statements between periods has not been materially affected by changes in the accounting principles employed or in the method of their application.

2. The consolidated financial statements of Rapid, Inc., and its subsidiary for the year ended December 31, 2008, would not be comparable with the prior year's statements of the parent (Rapid). This inconsistency would result in a qualified opinion in the audit report.

PROBLEM 2-11

Situation	*Applicable Standard of Reporting*	*Discussion of Relationship of Client Situation to Standard of Reporting and to Leer's Report*
A	Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.	Information essential to a fair presentation in conformity with generally accepted accounting principles should be set forth in the financial statements that include the related notes. Terms of loan agreements are essential information that should be disclosed in the financial statements or in the notes. When the client declines to disclose essential data or to incorporate it by reference in the notes, the auditor should provide such information in the auditor's report, usually in an explanatory paragraph, and the opinion should be appropriately qualified.
B	The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.	The improper presentation of material amounts of minority interest in net income and retained earnings constitutes a departure from generally accepted accounting principles. Although the minority shareholder should look to the subsidiary's financial statements for information, the minority interest presented on the consolidated statements is significant information for the readers of those statements. Because of the departure from generally accepted accounting principles, which violates the first standard of reporting, the auditor should express a qualified or adverse opinion. The auditor's report should disclose in a separate paragraph all the substantive reasons for the qualified or adverse opinion and the principal effects of the subject matter on financial position, results of operations, and changes in financial position.

PROBLEM 2-12

Brief Description of Generally Accepted Auditing Standards	*Holmes's Actions Resulting in Failure to Comply with Generally Accepted Auditing Standards*

General Standards

a) The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor.

a) It was inappropriate for Holmes to hire the two students to conduct the audit. The audit must be conducted by persons with proper education and experience in the field of auditing. Although junior assistants who have not completed their formal education may help in the conduct of an audit, there must be proper supervision and review.

b) In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.

b) To satisfy the second general standard, Holmes must be without bias with respect to the client under audit. Holmes has an obligation for fairness to the owners, management, creditors, and others who may rely on the report. Because of the financial interest in whether the bank loan is granted to Smith, Holmes is independent in neither fact nor appearance with respect to the assignment undertaken.

c) Due professional care is to be exercised in the performance of the audit and the preparation of the report.

c) This standard requires Holmes to perform the audit with due care, which imposes on Holmes and everyone in Holmes's organization a responsibility to observe the standards of fieldwork and reporting. Exercise of due care requires critical review at every level of supervision of the work done and the judgments exercised by those assisting in the audit. Holmes did not review the work or the judgments of the assistants and clearly failed to adhere to this standard.

Standards of Field Work

a) The work is to be adequately planned, and assistants, if any, are to be properly supervised.

a) This standard recognizes that early appointment of the auditor has advantages for the auditor and the client. Holmes accepted the engagement without considering the availability of competent staff. In addition, Holmes failed to supervise the assistants. The work performed was not adequately planned.

b) A sufficient understanding of internal controls should be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.

b) Holmes did not consider the internal controls, nor did the assistants. There appears to have been no audit at all. The work performed was more an accounting service than an auditing service.

Brief Description of Generally Accepted Auditing Standards	*Holmes's Actions Resulting in Failure to Comply with Generally Accepted Auditing Standards*
c) Sufficient, competent, evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a	c) Holmes acquired no evidence that would support the financial statements. Holmes merely checked the mathematical accuracy of

reasonable basis for an opinion regarding the financial statements under audit.	the records and summarized the accounts. Standard audit procedures and techniques were not performed.

Standards of Reporting

a) The report shall state whether the financial statements are presented with generally accepted accounting principles	a) Holmes's report made no reference to generally accepted accounting principles. Because Holmes did not conduct a proper audit, the report should state that no opinion can be expressed as to the fair presentation of the financial statements in accordance with generally accepted accounting principles.
b) The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.	b) Holmes's report makes no references to the consistent application of accounting principles. However, Holmes's improper audit was not appropriate to have drawn any conclusion on consistency.
c) Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.	c) Management is primarily responsible for adequate disclosure in the financial statements, but when the statements do not contain adequate disclosures, the auditor should make such disclosures in the auditor's report. In this case both the statements and the auditor's report lack adequate disclosures.
d) The report shall either contain an expression of opinion regarding the financial statements taken as a whole or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefore should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility she or he is taking.	d) Although the Holmes report contains an expression of opinion, such opinion is not based on the results of a proper audit. Holmes should disclaim an opinion because of the failure to conduct an examination in accordance with generally accepted auditing standards.

PROBLEM 2-13

1. Each component risk is defined below:
   a) *Inherent risk*: The susceptibility of an account balance to error that, when combined with error in other accounts, could be material and that is not monitored by related internal accounting controls.
   b) *Control risk*: The risk that error could occur and could be material when combined with error in other accounts but will not be prevented or detected by the system of internal accounting control.
   c) *Detection risk*: The risk that error could occur and could be material when combined with error in other accounts but will not be detected by the auditor's procedures.

2. Some accounts are more inherently risky than others because of either *external influences*, which are not monitored by internal accounting controls (e.g., technological developments), or *other influences*,

such as the liquidity of an account (e.g., liquid assets such as cash and securities are more inherently risky than coal or timber, which must be concealed and then converted into cash).

3. Detection risk is directly controllable by the auditor and therefore bears an inverse relationship to inherent and control risks, neither of which are controllable by the auditor.

4. Audit risk would be calculated as follows:

   AR = IR x CR x DR
   = .75 x .50 x .25
   = .09

   That is, approximately 9 percent.

5. a) With the new information, audit risk is now:

   AR = IR x CR x DR
   = .50 x .50 x .25
   = .06

   That is, approximately 6 percent.

   b) Since audit risk is lower (i.e., .06 versus .09), the auditor's materiality level will increase because there is an inverse relationship between audit risk and materiality.

PROBLEM 2-14

1. As proposed, the engagement is an assurance service other than an attestation, because the Medical Center is not making a *written* assertion. However, Dirksen & Co. may want to counter propose that the Medical Center make a written assertion and that Dirksen provide a written attestation, thereby casting the engagement as an attestation, providing Dirksen the comfort of an attestation report that imposes standard language (Chapter 3), and allowing Dirksen to perform the engagement using the profession's *attestation standards*.

2. Yes, the problem with the assurance service the Medical Center proposes is that the independent panel, although composed of AMA members, does not have the authority of the AMA in quite the same way that the FASB has the authority to develop accounting "rules" for financial statement audits. In short, although the assurer (Dirksen) will likely be viewed as independent by the Medical Center□s target audience, the panel of AMA members may not, since the target audience may view the panel as friendly to the Medical Center.

3. Unlike attestation and audit engagements, the profession has not yet compiled standards for assurance service engagements. However, the students should recognize that assurance standards would likely address the same four concepts as *attestation standards* and *GAAS*: independence, due care, evidence, and reporting.

PROBLEM 2-15

1. The statement, "material errors or irregularities is now *well below maximum*," reveals that, compared to 2007, control risk is lower in 2008. Because audit risk (of which control risk is a component) and materiality are inversely related, then the 2008 preliminary estimate of materiality will likely to higher.

2. The purpose of a preliminary estimate of materiality is to determine audit effort, which translates roughly to the number of audit hours an auditor would budget for an engagement to hold audit risk to a relatively low level. For example, if an auditor judges that audit risk is high, then he or she would

set the preliminary estimate of materiality relatively low and, therefore, allocate more audit hours to the engagement than if audit risk had been moderate.

PROBLEM 2-16

1. The concept of materiality refers to the relative significance of an account, activity, or item to informative disclosure and a proper presentation of financial position and the results of operations. Materiality has qualitative and quantitative aspects; both the nature of an item and its relative size enter into its evaluation.

   An accounting misstatement is said to be material if knowledge of the misstatement will affect the decisions of the average intelligent reader of the financial statements. Financial statements are misleading if they omit a material fact or include so many immaterial matters as to be confusing. In an examination, the auditor concentrates his or her efforts in proportion to degrees of materiality and relative risk and disregards immaterial items.

2. a. The materiality of an account or activity and the results of the review of internal control determine the scope of the auditor’s engagement. Emphasis will not be uniform among engagements; for example, more attention will be paid to inventories in a manufacturing company than in a service company. In the former, inventories normally constitute a large portion of assets, and misstatement vitally affects net income. In contrast, the quantities of supplies on hand at a service company usually are minor.

   b. In executing an audit program the auditor will stress review of the larger and more sensitive transactions. The auditor cannot ignore the transactions which are immaterial by themselves and material cumulatively, but a lower sampling rate may be used. When finding errors, the auditor must assess the degree of significance. In doing this, the auditor’s concept of materiality will not be based solely upon the size of the error, particularly if the error was noted in a test rather than a 100 percent review. When critical or significant errors are discovered in tests, the auditor will generally extend the scope of the examination to confirm his or her finding. Upon establishing an estimate of the degree of error present in the financial statements, the auditor may then discuss with the client the necessity for adjustment.

3. The relevant criteria for assessing materiality will depend upon the circumstances and the nature of the item and will vary greatly among companies. For example, an error in current assets or current liabilities will be more important for a company with a flow of funds problem than for one with adequate working capital. The effect upon net income (or earnings per share) is the most commonly used measure of materiality. This reflects the prime importance attached to net income by investors and other users of the statements. The effects upon assets and equities are also important, as are misstatements of individual accounts and subtotals included in the financial statements. The auditor will note the effects of misstatements on key ratios such as gross margin, the current ratio or the debt-equity ratio and will consider such special circumstances as the effects on debt agreement covenants and the legality of divided payments.

   There are no rigidly accepted standards or guidelines for assessing materiality. The lower bound of materiality has been variously estimated at 5 percent to 20 percent of net income, but the determination will vary based upon the individual case and might not fall within these limits. Certain items, such as a questionable loan to a company officer, may be considered material even when minor amounts are involved. In contrast, a large misclassification among expense accounts may not be deemed material if there is no misstatement of net income. The CPA will be more concerned with the relative size of the item (in terms of the particular company’s financial position and results of operations) than its absolute size. Usually the CPA will base decisions on the normal level of an account or activity. Thus, if reported net income this year is $100,000, but based on past experience and future expectations, normal net income is $1,000,000, an adjustment with an income effect of $20,000 probably will not be considered material unless unusual circumstances are involved. The income tax effect of errors also should be considered.

The auditor should determine and assess the effects of exceptions not only individually but also cumulatively. Adjustments passed in prior years because of immateriality should be included in this cumulative assessment to the extent that they affect the current year.

4. The CPA's assessment of the materiality of any exceptions to financial statements will influence the type of auditor's opinion as follows:
   a) *Unqualified Opinion* If the effects of a misstatement are immaterial, the auditor will make no opinion qualification.
   b) *Qualified Opinion* If the effects of a misstatement or uncertainty are material but the auditor can still render an overall favorable opinion as to fair presentation of financial position, results of operations, and cash flows, the auditor will qualify the opinion by the use of phrases including the terms "except" or "exception."
   c) *Adverse Opinion* If exceptions are so material that the auditor feels the overall financial position or results of operations are not presented fairly, she or he will issue an adverse opinion, stating that the financial statements do not present fairly the financial position or results of operations in conformity with generally accepted accounting principles. A disclaimer of opinion would not be appropriate in these circumstances.
   d) *Disclaimer of Opinion* If the scope of an engagement has been so limited or such unusual uncertainties exist that the auditor does not have sufficient evidence to form an opinion on the fairness of presentation of the financial statements as a whole, the auditor will disclaim any opinion on the financial statements.

PROBLEM 2-17

1. The student's best course of action is to use the decision aid illustrated in the chapter. In this case, total assets are $38,000,000 (Receivables of $2,500,000 + Inventory of $7,750,000 + Plant Assets of $15,000,000 + other assets of $12,750,000), and total estimated revenues are $35,000,000. Therefore, the larger of the two, total assets ($38,000,000), is used in the decision aid (see Figure 2-4 in the text), and the preliminary estimate of materiality is

$$\$178,000 = ([\$38,000,000 - \$30,000,000] \times .00312) = \$202,360$$

2. The allocation would be calculated as follows:

Preliminary estimate for all accounts	= $202,960
Sum of all balance sheet accounts	= $76,000,000
Accounts not audited	= -0-
Accounts audited 100 percent	= $3,000,000 (Payables)

Allocation:

$$\text{Accounts Receivable} = \$202,960 \times \sqrt{\frac{\$2,500,00}{(\$76,000,000 - \$3,000,000)}}$$

$$= \$37,560$$

$$\text{Inventory} = \$202{,}960 \times \sqrt{\frac{\$7{,}750{,}000}{(\$76{,}000{,}000 - \$3{,}000{,}000)}}$$

$$= \$66{,}130$$

$$\text{Plant Assets} = \$202{,}960 \times \sqrt{\frac{\$15{,}000{,}000}{(\$76{,}000{,}000 - \$3{,}000{,}000)}}$$

$$= \$92{,}000$$

PROBLEM 2-18

1. *SAS No. 47*, "Audit Risk and Materiality in Conducting an Audit," adopts the definition of materiality that appeared in the now nonauthoritative Statement of Financial Accounting Concepts No. 2: ". . . the magnitude of an omission or misstatement of accounting information that, in the judgment of a reasonable person relying on the information, would have been changed or influenced by the omission or misstatement." Stated another way, materiality is the maximum monetary misstatement the auditor will accept without concluding that an unqualified opinion is inappropriate.

2. Common financial statement relationships include both quantitative materiality criteria and qualitative criteria. Quantitative criteria include the percentage effect of an item on net income, on total revenues, and on total assets. Common qualitative criteria include the reversal of an earnings trend and the effects of immaterial payments.

3. In planning and executing an audit program, the auditor is concerned with the effect of materiality on the extent of auditing procedures applied. For example, as the materiality level decreases, the auditor would plan more extensive audit tests—i.e., increase the extent of procedures—because smaller transactions may in the aggregate add up to an amount that is material.