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STANDING ADVISORY GROUP MEETING

REASONABLE ASSURANCE

OCTOBER 5-6, 2005

Introduction

The Board's interim auditing standards[1/] require auditors to obtain reasonable assurance that the financial statements are free of material misstatements to support their unqualified opinion on the financial statements. This briefing paper discusses the concept of reasonable assurance and provides information to consider in deciding whether that concept is articulated with sufficient clarity and whether the standard of reasonable assurance is an appropriate level of auditor responsibility for the detection of material misstatements and for evaluating other areas of auditor performance.

The Concept of Reasonable Assurance

The assurance the auditor obtains from performing procedures and the assurance the auditor expresses in the report on the financial statements vary based on the type of service the auditor provides. An audit is the highest level of service an auditor can provide. An audit allows the auditor to express an opinion about whether

[1/] On April 16, 2003, the Board adopted certain pre-existing auditing standards as its interim auditing standards to be used on an initial, transitional basis. PCAOB Rule 3200T describes the auditing standards that the Board adopted and requires registered public accounting firms and their associated persons to comply with these interim auditing standards to the extent not superseded or amended by the Board. See the interim auditing standards at www.pcaob.org/standards.

the financial statements are free of material misstatement. In contrast, the objective of a review of interim financial information is to provide the auditor with a basis for communicating whether, as a result of the procedures performed, the auditor became aware of any modifications that should be made to the interim financial information for it to conform with generally accepted accounting principles ("GAAP"). The procedures performed in a review do not provide the auditor with a basis for expressing an opinion on the financial statements. Thus, the assurance the auditor provides to financial statement users based on a review is more limited than the assurance that can be provided as a result of an audit.

The term "reasonable assurance," as used in the interim auditing standards, describes the level of assurance auditors are required to obtain by performing audit procedures and evaluating the resulting audit evidence when expressing an opinion that the financial statements are fairly presented in conformity with GAAP. Reasonable assurance refers to the auditor's degree of satisfaction that the evidence obtained during the performance of the audit supports the assertions embodied in the financial statements. The auditor's standard report on the audit of financial statements explicitly asserts in the scope paragraph that the audit was conducted in accordance with professional standards and states that "those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement."

Defining Reasonable Assurance

Paragraph 17 of PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*, describes reasonable assurance as follows:

> Management's assessment of the effectiveness of internal control over financial reporting is expressed at the level of reasonable assurance . . . Reasonable assurance includes the understanding that there is a remote likelihood that material misstatements will not be prevented or detected on a timely basis. Although not absolute assurance, reasonable assurance is, nevertheless, a high level of assurance.

The description of reasonable assurance in PCAOB Auditing Standard No. 2, in the context of an audit of internal control over financial reporting, explicitly states that reasonable assurance is a high level of assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes.

However, in the context of a financial statement audit, the term "reasonable assurance" is not explicitly defined. Rather than defining what reasonable assurance is, the interim auditing standards explain reasonable assurance by contrasting it with absolute assurance. For example –

> The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Because of the nature of audit evidence and the characteristics of fraud, the auditor is able to obtain reasonable, but not absolute, assurance that material misstatements are detected. The auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by errors or fraud, that are not material to the financial statements are detected. (AU sec. 110.02)

> The exercise of due professional care allows the auditor to obtain *reasonable assurance* that the financial statements are free of material misstatement, whether caused by error or fraud. Absolute assurance is not attainable because of the nature of the audit evidence and the characteristics of fraud. Therefore, an audit conducted in accordance with generally accepted auditing standards may not detect a material misstatement. (AU sec. 230.10)

Thus, the interim auditing standards convey the idea that reasonable assurance is less than absolute assurance, but they do not explicitly define reasonable assurance; rather, they state what reasonable assurance is not.

Because reasonable assurance is not explicitly defined in the interim auditing standards, both auditors and financial statement users may misunderstand the level of assurance the auditor is required to obtain in an audit before opining on the financial statements. For example, the Public Oversight Board's Panel on Audit Effectiveness ("PAE") expressed concern that auditors may not be requiring as much evidence to achieve reasonable assurance as they have in the past, especially in areas in which they believe that risk is low.[2/]

What Level of Assurance Is Reasonable Assurance?

Because reasonable assurance is less than absolute assurance, the interim auditing standards are clear that it is less than certainty or, in quantitative terms, less than 100 percent. But how much less is not stated.

Some insight into what reasonable assurance means to the auditor may be gained by recognizing that it is the complement of audit risk. Audit risk is defined in AU sec. 312, *Audit Risk and Materiality in Conducting an Audit,* as "the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated." The interim auditing standards describe the relationship between audit risk and assurance as follows –

> The existence of audit risk is recognized in the description of the responsibilities and functions of the independent auditor that states, 'Because of the nature of audit evidence and the characteristics of fraud, the auditor is able to obtain reasonable, but not absolute, assurance that material misstatements are detected.' (AU sec. 312.02)

The interim auditing standards also state the following about the risk/assurance relationship –

- The auditor should plan the audit so that audit risk will be limited to a low level that is, in his or her professional judgment, appropriate for expressing an opinion on the financial statements. (AU sec. 312.13)

- Audit risk may be assessed in quantitative or nonquantitative terms. (AU sec. 312.13)

- The auditor should seek to restrict audit risk at the individual account-balance or class-of-transactions level in such a way that will enable him or her, at the completion of the audit, to express an opinion on the financial

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[2/] Public Oversight Board, The Panel on Audit Effectiveness, *Report and Recommendations* (2000), par. 3.28.

> statements taken as a whole at an appropriately low level of audit risk. (AU sec. 312.26)

Because the auditor must limit overall audit risk to a low level, reasonable assurance must be at a high level. Stated in mathematical terms, if audit risk is 5 percent, then the level of assurance is 95 percent. The relationship is not normally quantified at the financial statement level, but the relationship between risk and assurance is incontrovertible, and the interim auditing standards explicitly make the connection.

Other professional standards also articulate the concept of reasonable assurance as a high level of assurance. For example, the glossary of terms that accompanies the pronouncements of the International Auditing and Assurance Standards Board defines reasonable assurance, both in the context of an audit engagement and quality control, as a high, but not absolute, level of assurance.[3/] In addition, IFAC's Code of Ethics for Professional Accountants defines an audit engagement as –

> An assurance engagement to provide a high level of assurance that financial statements are free of material misstatement, such as an engagement in accordance with International Standards on Auditing. This includes a statutory audit which is an audit required by national legislation or other regulation.

Comments made by some members of the Standing Advisory Group at the September 8-9, 2004, SAG meeting provide anecdotal indications that at least some investors and other financial statement users are uncertain about the level of assurance described by the term "reasonable assurance." For example, one member expressed the view that the language in the interim auditing standards describing the inherent limitations of an audit may create the impression that reasonable assurance is not a high level of assurance. Furthermore, this member suggested that auditors should be required to apply procedures such as maintaining a heightened skepticism about the possibility of fraud throughout the audit and focusing specific audit procedures on high-risk areas that would allow the auditor to express a high level of assurance on the financial statements, rather than reasonable assurance. Another member expressed

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[3/] The International Auditing and Assurance Standards Board ("IAASB") was established by the International Federation of Accountants ("IFAC") to promulgate International Standards on Auditing ("ISA"s) and other related pronouncements.

the view that the term "reasonable assurance" conveyed a low level of assurance when compared to the clear expression of "high but not absolute" assurance used in the international auditing standards.

Using Different Terms to Define Reasonable Assurance

Because both auditors and financial statement users have preconceptions about the meaning of the term "reasonable assurance," it may be helpful to articulate the auditor's responsibility to obtain satisfaction about the reliability of the assertions embodied in the financial statements using terms other than reasonable assurance. For example, using words with which auditors are familiar because they are defined in Financial Accounting Standards Board ("FASB") Statements of Financial Accounting Standards ("FASB Statement"), the auditor's responsibility could be articulated as "planning and performing the audit in a manner that makes it probable, though not a certainty, that the financial statements are free of material misstatement." The term "probable" is defined in FASB Statement No. 5, *Accounting for Contingencies,* as "likely" and also conveys a high level of assurance.

Discussion Questions –

1. Is there a need for a concise definition of the term "reasonable assurance?"

2. Should the term "reasonable assurance," as used in the interim auditing standards, be described as a high level of assurance? Or, is there another definition or description that is more appropriate?

3. Should the assurance that the auditor obtains be expressed using terms other than reasonable assurance? If so, what terms better articulate the auditor's assurance level?

Is Reasonable Assurance an Appropriate Level of Responsibility?

Paragraph .10 of AU sec. 230, *Due Professional Care in the Performance of Work*, states that "absolute assurance is not attainable because of the nature of audit evidence and the characteristics of fraud."

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Nature of Audit Evidence

The limitation on the level of assurance that can be obtained by the auditor due to the nature of audit evidence generally results from two matters: (1) the concept of selective testing and (2) the fact that accounting presentations include accounting estimates that are inherently uncertain. AU sec. 230.11 states –

> The nature of most evidence derives, in part, from the concept of selective testing of the data being audited, which involves judgment regarding both the areas to be tested and the nature, timing, and extent of the tests to be performed. In addition, judgment is required in interpreting the results of audit testing and evaluating audit evidence. Even with good faith and integrity, mistakes and errors in judgment can be made. Furthermore, accounting presentations contain accounting estimates, the measurement of which is inherently uncertain and depends on the outcome of future events. The auditor exercises professional judgment in evaluating the reasonableness of accounting estimates based on information that could reasonably be expected to be available prior to the completion of field work. As a result of these factors, in the great majority of cases, the auditor has to rely on evidence that is persuasive rather than convincing.

Selective testing is necessary to perform an audit within reasonable time and cost constraints, but audit sampling techniques, if properly applied, can help the auditor control the level of assurance achieved through selective testing.

Accounting estimates are an integral part of financial statements. Management's judgment in making estimates is normally based on its knowledge and experience about past and current events and its assumptions about conditions it expects to exist and courses of action it expects to take. Because estimates are approximations of financial statement amounts based on subjective as well as objective factors, they are less precise than other financial statement amounts. Further, some accounting estimates have a higher degree of uncertainty than others. For example, environmental loss reserves are generally more uncertain than the collectibility of a receivable from a customer. These differences in uncertainty can be adequately disclosed[4/] in the financial statement presentation and understood by a user.

[4/] See Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties* (AICPA, *Professional Standards*, vol. 1, June 1, 2003).

In addition, even when management's estimation process involves competent personnel using relevant and reliable data, there is potential for bias in the subjective factors. The interim auditing standards state that "the risk of material misstatement of the financial statements is generally greater when account balances and classes of transactions include accounting estimates rather than essentially factual data because of the inherent subjectivity in estimating future events." (AU sec. 312.36)

Furthermore, fraudulent financial reporting often is accomplished through intentional misstatement of accounting estimates. Accounting estimates that involve subjective judgments that are difficult to corroborate may be used to intentionally distort the financial statements. In addition, estimates included in the financial statements that are individually reasonable may, in the aggregate, indicate a bias on the part of management. For example, if each accounting estimate included in the financial statements was individually reasonable but the effect of the difference between each estimate and the estimate best supported by the audit evidence was to increase income, management may have biased the estimates in a manner that attempts to manipulate earnings.

Characteristics of Fraud

The characteristics of fraud that are identified as making absolute assurance unattainable and that create a possibility that a properly planned and performed audit may not detect a material misstatement are described in AU sec. 230.12 as follows –

> Characteristics of fraud include (a) concealment through collusion among management, employees, or third parties; (b) withheld, misrepresented, or falsified documentation; and (c) the ability of management to override or instruct others to override what otherwise appears to be effective controls. For example, auditing procedures may be ineffective for detecting an intentional misstatement that is concealed through collusion among personnel within the entity and third parties or among management or employees of the entity. Collusion may cause the auditor who has properly performed the audit to conclude that evidence provided is persuasive when it is, in fact, false. In addition, an audit conducted in accordance with generally accepted auditing standards rarely involves authentication of documentation, nor are auditors trained as or expected to be experts in such authentication. Furthermore, an auditor may not

> discover the existence of a modification of documentation through a side agreement that management or a third party has not disclosed. Finally, management has the ability to directly or indirectly manipulate accounting records and present fraudulent financial information by overriding controls in unpredictable ways.

The mere presence of collusion, false documents, or management override does not necessarily impede the auditor's ability to detect fraud, however. Acts of concealment vary considerably in complexity and sophistication and do not have a uniform effect on the auditor's ability to detect fraud. The auditor should recognize that most fraudulent financial reporting involves collusion in the sense that several members of senior management or employees might be involved and that, in many instances, falsified documentation is presented to the auditor. The auditor should therefore plan and perform the audit and evaluate the results of auditing procedures with the possibility in mind of collusion and falsification of documents.

Furthermore, there are forms of collusion that should not necessarily impede an effective audit because they are known to auditors to be a common feature of fraud. For example, many instances of fraudulent financial reporting involve both the CEO and CFO. The fact that a CEO and CFO collude to make similar misrepresentations to the auditor should not necessarily impede the detection of fraud involving material misstatements of assets, earnings, or cash flows.

Document manipulation also varies in the degree to which it impedes detection. A competent auditor should recognize that a copy of a document is more subject to alteration than an original, that data received electronically into the client's system might be readily manipulated depending on the strength of relevant controls, and that documents created internally when controls are weak are less reliable than those obtained when relevant controls are effective. The auditor also should recognize alterations that are obvious on their face. On the other hand, an auditor would likely be unable to detect a skilled forged signature. Auditors are not experts at authenticating documents, but a large part of their work involves inspecting documents, and auditors are very familiar with the characteristics of a variety of common business documents.

Management override of controls also is a common feature of fraudulent financial reporting. The interim auditing standards require the auditor to perform several procedures that, if applied effectively, would promote fraud detection. For example, AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, requires auditors to perform the following procedures –

- Understand the company's controls over journal entries and test specific items.

- Review accounting estimates for management biases.

- Understand the business rationale for significant transactions that are outside of the normal course of business.

Because errors are unintentional and random, material misstatements caused by error are likely to be detected by a properly planned and performed audit. In contrast, the characteristics of fraud, as previously discussed, influence the likelihood that material misstatement caused by fraud will be detected.

Even though the interim auditing standards clearly state that reasonable assurance pertains to the absence of misstatements whether caused by error or fraud, these standards do not explicitly state that the auditor must obtain the same level of assurance regarding the absence of material misstatement whether the cause of the misstatement is intentional (fraud) or unintentional (error).

Discussion Questions –

4. Should the auditor be required to obtain the same level of assurance with respect to material misstatements in the financial statements, whether caused by error or fraud?

5. How should the description of the auditor's ability to obtain a high level of assurance be affected by the possibility of collusion, management override of controls, or falsification of documents?

6. Is reasonable assurance an appropriate level of auditor responsibility for auditing certain accounting estimates given the imprecision and subjectivity inherent in accounting estimates?

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Expressing Reasonable Assurance in the Auditor's Report

The scope paragraph of the auditor's standard report includes the following elements –

- An explicit statement of the auditor's responsibility under standards of the PCAOB to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.

- A description, in general terms, of the audit procedures required to be performed as follows: (a) examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, (b) assessing the accounting principles used and significant estimates made by management, and (c) evaluating the overall financial statement presentation.

- The auditor's conclusion that the audit procedures performed provide a reasonable basis for the auditor's opinion.

Obtaining reasonable assurance enables the auditor to express an opinion as to whether the financial statements are free of material misstatement. The standard unqualified opinion states –

> In our opinion, the financial statements present fairly, in all material respects, the financial position and results of operations and cash flows in conformity with accounting principles generally accepted in the United States of America.

Thus, the assurance that the auditor provides to the user of the audited financial statements is implicit in his or her report. The auditor's report refers only to the level of assurance obtained by the auditor, and his or her opinion on the financial statements does not explicitly state the level of assurance that the user receives.

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Discussion Question –

7. Should the auditor explicitly state the level of assurance provided to the user as a result of the audit? Similarly, should the auditor state the level of assurance the auditor obtained as a result of the audit?

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