1979

Proposed statement on auditing standards, financial statement assertions, related audit objectives, and the design of substantive tests;Financial statement assertions, related audit objectives, and the design of substantive tests; Exposure draft (American Institute of Certified Public Accountants), 1979, Dec. 31

American Institute of Certified Public Accountants. Auditing Standards Board

EXPOSURE DRAFT

PROPOSED STATEMENT ON AUDITING STANDARDS

FINANCIAL STATEMENT ASSERTIONS, RELATED AUDIT OBJECTIVES, AND THE DESIGN OF SUBSTANTIVE TESTS

DECEMBER 31, 1979

Prepared by the AICPA Auditing Standards Board
for comments from persons interested in auditing and reporting

Comments should be received by March 30, 1980, and addressed
to AICPA Auditing Standards Division, File 2550
AICPA, 1211 Avenue of the Americas, New York, N.Y. 10036

AICPA

American Institute of Certified Public Accountants

1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

December 31, 1979

An exposure draft of a proposed Statement on Auditing Standards entitled Financial Statement Assertions, Related Audit Objectives, and the Design of Substantive Tests accompanies this letter.

The proposed Statement describes the broad categories of financial statement assertions referred to in SAS No. 1, section 330, "Evidential Matter," and provides guidance to the auditor on how to consider them in (a) developing audit objectives and (b) designing substantive tests to achieve those objectives. The proposed Statement does not modify section 330 but provides additional guidance to help the auditor in selecting procedures in specific circumstances.

Comments or suggestions on any aspect of the exposure draft will be appreciated. The AICPA Auditing Standards Board's consideration of responses will be helped by explanations of the reasons for comments.

In developing guidance, the AICPA Auditing Standards Board considers the relationship between the cost imposed and the benefits reasonably expected to be derived from audits. It also considers differences that the auditor may encounter in the audit of the financial statements of small businesses and, when appropriate, makes special provisions to meet those needs. Thus, the board would particularly appreciate comments on those matters.

Responses should be addressed to the AICPA Auditing Standards Division, File 2550, in time to be received by March 30, 1980. Written comments on the exposure draft will become part of the public record of the AICPA Auditing Standards Division and will be available for public inspection at the offices of the American Institute of Certified Public Accountants after April 15, 1980, for one year.

Sincerely,

James J. Leisenring

James J. Leisenring, Chairman
Auditing Standards Board

D. R. Carmichael

D. R. Carmichael
Vice President, Auditing

This exposure draft has been sent to

- *practice offices of CPA firms*
- *members of AICPA Council and technical committee chairmen*
- *state society and chapter presidents, directors, and committee chairmen*
- *organizations concerned with regulatory, supervisory, or other public disclosure of financial activities*
- *persons who have requested copies*

PROPOSED STATEMENT ON AUDITING STANDARDS

FINANCIAL STATEMENT ASSERTIONS, RELATED AUDIT OBJECTIVES, AND THE DESIGN OF SUBSTANTIVE TESTS

1. Statement on Auditing Standards No. 1, section 330, refers to "individual assertions in financial statements." Section 330.11 states that "to the extent the auditor remains in substantial doubt as to any assertion of material significance, he must refrain from formulating an opinion until he has obtained sufficient competent evidential matter to remove such substantial doubt, or he must express a qualified opinion or a disclaimer of opinion." The purpose of this Statement is to describe broad categories of financial statement assertions and provide guidance to the auditor on how to consider them in (*a*) developing audit objectives and (*b*) designing substantive tests to achieve those objectives.

2. In selecting particular substantive tests to achieve the audit objectives he has developed, the auditor considers, among other things, the extent of reliance, if any, to be placed on internal accounting control and the expected effectiveness and efficiency of such tests. His considerations include the nature and materiality of the items being tested and the relative risk of errors or irregularities that would be material to financial statements. The combination of the auditor's reliance on internal accounting control and on selected substantive tests should provide a reasonable basis for his opinion (see SAS No. 1, section 320.73).

NATURE OF ASSERTIONS

3. Assertions are representations by management that are embodied in elements of financial statements. They can be either explicit or implicit. The broad categories of assertions can be classified as follows:

- Existence or occurrence
- Completeness
- Rights and obligations
- Valuation or allocation
- Presentation and disclosure

4. Assertions about existence or occurrence deal with whether assets or liabilities of the entity exist at a given date and whether transactions reflected in the income statement have occurred during a given period. For example, management asserts that finished goods inventories reflected on the balance sheet are available for sale. Similarly, management asserts that sales reflected in the income statement represent the exchange of goods or services with customers for cash or other consideration.

5. Assertions about completeness deal with whether all transactions and accounts that should be reflected in the financial statements are reflected therein. For example, management asserts that all purchases of goods and services are recorded and are included in the financial statements. Similarly, management asserts that notes payable in the balance sheet include all such obligations of the entity.

6. Assertions about rights and obligations deal with whether assets are the rights of the entity and liabilities are the obligations of the entity at a given date. For example, management asserts that amounts capitalized for leases in the balance sheet represent the cost of the entity's rights to leased property and that the corresponding lease liability represents an obligation of the entity.

7. Assertions about valuation or allocation deal with whether assets, liabilities, revenue, and expense elements have been reflected in the financial statements at appropriate amounts. For example, management asserts that property is recorded at historical cost and that such cost is systematically allocated to appropriate accounting periods. Similarly, management asserts that trade accounts receivable reflected in the balance sheet are stated at net realizable value.

8. Assertions about presentation and disclosure deal with whether particular elements of the financial statements are properly classified, described, and disclosed. For example, management asserts that obligations classified as long-term liabilities in the balance sheet will not mature within one year. Similarly, management asserts that amounts reflected as extraordinary items in the income statement are properly classified and described.

DEVELOPING AUDIT OBJECTIVES

9. The first step involved in obtaining evidential matter in support of financial statement assertions is to translate the assertions into specific audit objectives. The audit objectives of a particular engagement should be developed in light of the specific circumstances of the entity, including the nature of its economic activity and the accounting practices unique to its industry. For example, the following audit objectives might be developed for inventory balances of a manufacturing company from the broad categories of assertions listed in paragraph 3.

Assertions and Illustrative Audit Objectives

Existence or Occurrence

Audit Objectives

- Inventories reflected on the balance sheet physically exist.
- Inventories represent items held for sale or use in the normal course of business.

Completeness

Audit Objectives

- Inventory quantities include all products, materials, and supplies on hand.

- Inventory quantities include all products, materials, and supplies owned by the company that are in transit or stored at outside locations.
- Inventory listings are accurately compiled, and the totals are properly reflected in the inventory accounts.

Rights and Obligations

Audit Objectives

- The entity has legal title or similar rights of ownership to the inventories.
- Inventories exclude items billed to customers or owned by others.

Valuation or Allocation

Audit Objectives

- Inventories are properly stated at cost (except when market is lower).
- Slow-moving, excess, defective, and obsolete items included in inventories are properly identified.
- Inventories are reduced, when appropriate, to replacement cost or net realizable value.

Presentation and Disclosure

Audit Objectives

- Inventories are properly classified in the balance sheet as current assets.
- The major categories of inventories and their bases of valuation are adequately disclosed in the financial statements.
- The pledging or assignment of any inventories is appropriately disclosed.

DESIGNING SUBSTANTIVE TESTS

10. There is not necessarily a one-to-one relationship between audit objectives and procedures. Some auditing procedures may relate to more than one objective. On the other hand, a combination of auditing procedures may be needed to achieve a single objective. Paragraphs 11 through 15 give examples of substantive tests that may achieve the illustrative audit objectives noted in paragraph 9 for inventories of a manufacturing company. In designing the particular substantive tests to achieve these objectives, the auditor should consider, among other things, the extent of reliance to be placed on internal accounting control over the inventories and the anticipated efficiency and effectiveness of the substantive tests.

11. Examples of substantive tests that may achieve the objective concerning physical existence of inventories could include observing physical inventory counts and obtaining confirmation of inventories at locations outside the entity. This objective might also be achieved, in part, by examining perpetual inventory records, production records, or purchasing records, such as vendors' invoices and receiving reports. The latter procedures, plus the review of subsequent sales and delivery reports and the use of the work of experts to corroborate the nature of specialized products, might also serve to achieve the objective concerning whether inventories represent items held for sale or use in the normal course of business.

12. Observing physical counts and obtaining confirmation of inventories not on hand also may help to achieve, respectively, the first two illustrative audit objectives relating to the completeness of the inventory balances. However, these objectives might be achieved to some extent by reviewing the analytical relationship of inventory balances to recent purchasing, production, and sales activity, examining analyses of general ledger account activity, and testing shipping and receiving cutoff procedures. The other illustrative audit objective relating to completeness (inventory listings are accurately compiled and the totals are properly reflected in the inventory accounts) might be achieved by tracing test counts recorded during the physical inventory observation to the inventory listing, accounting for all inventory tags and count sheets noted during the count, testing the clerical accuracy of inventory listings, and reconciling physical counts to perpetual records and general ledger balances and investigating any differences.

13. To consider whether the entity has rights of ownership to inventories the auditor also might rely on the observation of physical counts and the confirmation of inventories at outside locations in combination with examining paid vendors' invoices, consignment agreements, and contracts. Examining such documents as well as testing shipping and receiving cutoff procedures may also serve to provide assurance that inventories exclude items billed to customers or owned by others.

14. A variety of substantive tests are available to achieve the three illustrative audit objectives related to the valuation of inventories. To consider whether inventories are properly stated at cost (except where market is lower), the auditor may examine paid vendors' invoices, review direct labor rates, test the computation of standard overhead rates, and examine analyses of purchasing and manufacturing standard cost variances. To consider whether slow-moving, excess, defective, and obsolete items included in inventories are properly identified, the auditor may examine inventory turnover schedules, review industry experience and trends, review the analytical relationship of inventory balances to anticipated sales volume, tour the plant, and inquire of production and sales personnel concerning possible excess or obsolete inventory items. Finally, to consider whether inventories are reduced, when appropriate, to reflect replacement cost or net realizable value, the auditor may obtain current market value quotations, review current production costs, test computations of net realizable value, and examine open purchase order commitments.

15. The illustrative audit objective related to disclosure of the pledging or assignment of any inventories might be achieved by obtaining confirmation of inventories pledged under loan agreements. The other two illustrative audit objectives relating to the presentation and disclosure of inventory balances would normally be achieved in connection with the review of financial statements and the comparison of disclosures made therein to the requirements set forth in the professional accounting literature.

16. The illustrative substantive tests in paragraphs 11 through 15 are not intended to be all-inclusive, nor is it expected that all of the proce-

dures would be applied in any examination. The nature, timing, and extent of the procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific circumstances. However, the procedures adopted should be adequate to achieve the audit objectives, and the evidential matter obtained should provide a reasonable basis for the auditor's conclusions concerning the validity of the individual assertions embodied in the elements of financial statements.