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Proposed statement on auditing standards: performing audit procedures in response to assessed risks and evaluating the audit evidence obtained; Exposure draft (American Institute of Certified Public Accountants), 2008

American Institute of Certified Public Accountants. Auditing Standards Board

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PROPOSED STATEMENT ON AUDITING STANDARDS
PERFORMING AUDIT PROCEDURES IN RESPONSE TO ASSESSED RISKS AND
EVALUATING THE AUDIT EVIDENCE OBTAINED

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PROPOSED STATEMENT ON AUDITING STANDARDS

PERFORMING AUDIT PROCEDURES IN RESPONSE TO ASSESSED RISKS AND EVALUATING THE AUDIT EVIDENCE OBTAINED

INTRODUCTION

1. This Statement establishes standards and provides guidance on determining overall responses and designing and performing further audit procedures to respond to the assessed risks of material misstatement¹ at the financial statement and relevant assertion levels in a financial statement audit, and on evaluating the sufficiency and appropriateness of the audit evidence obtained. In particular, this Statement provides guidance about implementing the third standard of field work, as follows:

The auditor must obtain sufficient appropriate audit evidence through audit procedures performed to afford a reasonable basis for an opinion regarding the financial statements taken as a whole.

2. The following is an overview of this standard:

- *Overall responses.* This section provides guidance to the auditor in determining overall responses to address risks of material misstatement at the financial statement level and provides guidance on the nature of those responses.
- *Audit procedures responsive to risks of material misstatement at the relevant assertion level.* This section provides guidance to the auditor in designing and performing further audit procedures, including tests of the operating effectiveness of controls, where relevant or necessary, and substantive procedures, whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the relevant assertion level. In addition, this section includes matters the auditor should consider in determining the nature, timing, and extent of such audit procedures.
- *Evaluating the sufficiency and appropriateness of audit evidence obtained.* This section provides guidance to the auditor in evaluating whether the risk assessments remain appropriate and to conclude whether sufficient appropriate audit evidence has been obtained.
- *Documentation.* This section establishes related documentation guidance.

3. In order to reduce audit risk to an acceptably low level, the auditor should determine overall responses to address the assessed risks of material misstatement at the financial statement level, and should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the relevant assertion level.² The overall responses and the nature, timing, and extent of the further audit procedures to be performed are matters for the professional judgment of the auditor.

¹ Risk of material misstatement is described as the auditor's combined assessment of inherent risk and control risk. See paragraph 22 of the proposed Statement on Auditing Standards (SAS) *Audit Risk and Materiality in Conducting an Audit (Audit Risk and Materiality)*, for the definition of and discussion about risk of material misstatement.

² See paragraph 103 of the proposed SAS *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement (Assessing Risks)*.

4. In addition to the guidance in this Statement, the auditor should comply with the guidance in Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), in responding to assessed risks of material misstatements due to fraud.

OVERALL RESPONSES³

5. The auditor's overall responses to address the assessed risks of material misstatement at the financial statement level may include emphasizing to the audit team the need to maintain professional skepticism in gathering and evaluating audit evidence, assigning more experienced staff or those with specialized skills or using specialists, providing more supervision, or incorporating additional elements of unpredictability in the selection of further audit procedures to be performed. Additionally, the auditor may make general changes to the nature, timing, or extent of audit procedures as an overall response, for example, performing substantive procedures at period end instead of at an interim date.

6. The assessment of the risks of material misstatement at the financial statement level is affected by the auditor's understanding of the control environment. An effective control environment may allow the auditor to have more confidence in internal control and the reliability of audit evidence generated internally within the entity and thus, for example, allow the auditor to perform some audit procedures at an interim date rather than at period end. If there are weaknesses in the control environment, the auditor, should, for example, conduct more audit procedures as of the period end rather than at an interim date, seek more extensive audit evidence from substantive procedures, modify the nature of audit procedures to obtain more persuasive audit evidence, or increase the number of locations to be included in the audit scope.

7. Such considerations, therefore, have a significant bearing on the auditor's general approach, for example, an emphasis on substantive procedures (substantive approach), or an approach that uses tests of controls as well as substantive procedures (combined approach).

AUDIT PROCEDURES RESPONSIVE TO RISKS OF MATERIAL MISSTATEMENT AT THE RELEVANT ASSERTION LEVEL

8. The auditor should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the relevant assertion level. The purpose is to provide a clear linkage between the nature, timing, and extent of the auditor's further audit procedures and the risk assessments. In designing further audit procedures, the auditor should consider such matters as:

- The significance of the risk
- The likelihood that a material misstatement will occur
- The characteristics of the class of transactions, account balance, or disclosure involved
- The nature of the specific controls used by the entity in particular whether they are manual or automated
- Whether the auditor expects to obtain audit evidence to determine if the entity's controls are effective in preventing or detecting material misstatements.

³ See paragraphs 13 through 17 of the proposed SAS *Planning and Supervision* for further guidance on the auditor's overall audit strategy.

The nature of the audit procedures is of most importance in responding to the assessed risks.

9. The auditor's assessment of the identified risks at the relevant assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit procedures. In some cases, the auditor may determine that performing only substantive procedures is appropriate for specific relevant assertions and risks. In those circumstances, the auditor excludes the effect of controls from the relevant risk assessment. This may be because the auditor's risk assessment procedures have not identified any effective controls relevant to the assertion, or because testing the operating effectiveness of controls would be inefficient. However, the auditor needs to be satisfied that performing only substantive procedures for the relevant assertions would be effective in reducing the risk of material misstatement to an acceptably low level.⁴ In other cases, the auditor may determine that performing tests of the operating effectiveness of controls is an effective response to the assessed risk of material misstatement for a particular relevant assertion. However, the auditor often will determine that a combined approach using both tests of the operating effectiveness of controls and substantive procedures is an effective approach.

10. Regardless of the audit approach selected, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure as specified by paragraph 52. Because internal controls generally reduce, but do not eliminate the risk of material misstatement, tests of controls reduce, but do not eliminate, the need for substantive procedures. In addition, analytical procedures alone may not be sufficient in some cases. For example, when auditing certain estimation processes such as examining the allowance for doubtful accounts, the auditor may perform substantive procedures beyond analytical procedures (for example, examining cash collections subsequent to period end) due to the risk of management override or the subjectivity of the account balance.

11. In the case of very small entities, there may not be many control activities that could be identified by the auditor. For this reason, the auditor's further audit procedures are likely to be primarily substantive procedures. In such cases, in addition to the matters referred to in paragraph 9, the auditor should consider whether in the absence of controls it is possible to obtain sufficient appropriate audit evidence.

Considering the Nature, Timing, and Extent of Further Audit Procedures

Nature

12. The nature of further audit procedures refers to their purpose (tests of controls or substantive procedures)⁵ and their type, that is, inspection, observation, inquiry, confirmation, recalculation, reperformance, or analytical procedures. Certain audit procedures may be more appropriate for some assertions than others. For example, in relation to revenue, tests of controls may be most responsive to the assessed risk of misstatement of the completeness assertion, whereas substantive procedures may be most responsive to the assessed risk of misstatement of the occurrence assertion.

⁴ Paragraphs 118 through 121 of the proposed SAS *Assessing Risks* describe circumstances where the auditor may determine that it is not possible or practicable to reduce the risks of material misstatement at the assertion level to an appropriately low level with audit evidence obtained only from substantive procedures.

⁵ Audit procedures performed for the purpose of assessing risk (risk assessment procedures) are discussed in paragraphs 6 through 13 of the proposed SAS *Assessing Risks*.

13. The auditor's selection of audit procedures is based on the risk of material misstatement. The higher the auditor's assessment of risk, the more reliable and relevant is the audit evidence sought by the auditor from substantive procedures. This may affect both the types of audit procedures to be performed and their combination. For example, the auditor may confirm the completeness of the terms of a contract with a third party, in addition to inspecting the document and obtaining management's representation.

14. In determining the audit procedures to be performed, the auditor should consider the reasons for the assessment of the risk of material misstatement at the relevant assertion level for each class of transactions, account balance, and disclosure. This includes considering both the particular characteristics of each class of transactions, account balance, or disclosure (that is, the inherent risks) and whether the auditor's risk assessment takes account of the entity's controls (that is, the control risk). For example, if the auditor considers that there is a lower risk that a material misstatement may occur because of the particular characteristics of a class of transactions (without consideration of the related controls), the auditor may determine that substantive analytical procedures alone may provide sufficient appropriate audit evidence. On the other hand, if the auditor expects that there is a lower risk that a material misstatement may occur because an entity has effective controls and the auditor intends to design substantive procedures based on the effective operation of those controls, then the auditor should perform tests of controls to obtain audit evidence about their operating effectiveness. This may be the case for a class of transactions of reasonably uniform, noncomplex characteristics that are routinely processed and controlled by the entity's information system.

15. The auditor should obtain audit evidence about the accuracy and completeness of information produced by the entity's information system when that information is used in performing audit procedures. For example, if the auditor uses nonfinancial information or budget data produced by the entity's information system in performing audit procedures, such as substantive analytical procedures or tests of controls, the auditor should obtain audit evidence about the accuracy and completeness of such information. See paragraph 10 of the proposed *SAS Audit Evidence* for further guidance.

Timing

16. Timing refers to when audit procedures are performed or the period or date to which the audit evidence applies.

17. The auditor may perform tests of controls or substantive procedures at an interim date or at period end. The higher the risk of material misstatement, the more likely it is that the auditor may decide it is more effective to perform substantive procedures nearer to, or at, the period end rather than at an earlier date, or to perform audit procedures unannounced or at unpredictable times (for example, performing audit procedures at selected locations on an unannounced basis). On the other hand, performing audit procedures before the period end may assist the auditor in identifying significant matters at an early stage of the audit, and consequently resolving them with the assistance of management or developing an effective audit approach to address such matters. If the auditor performs tests of the operating effectiveness of controls or substantive procedures before period end, the auditor should consider the additional evidence that is necessary for the remaining period (see paragraphs 38 through 40, and 59 through 66).

18. In considering when to perform audit procedures, the auditor should also consider such matters as:

- The control environment

- When relevant information is available (for example, electronic files may subsequently be overwritten, or procedures to be observed may occur only at certain times)
- The nature of the risk (for example, if there is a risk of inflated revenues to meet earnings expectations by subsequent creation of false sales agreements, the auditor may examine contracts available on the date of the period end)
- The period or date to which the audit evidence relates

19. Certain audit procedures can be performed only at or after period end, for example, agreeing the financial statements to the accounting records, or examining adjustments made during the course of preparing the financial statements. If there is a risk that the entity may have entered into improper sales contracts or transactions may not have been finalized at period end, the auditor should perform procedures to respond to that specific risk. For example, when transactions are individually material or an error in cutoff may lead to material misstatement, the auditor should inspect transactions near the period end.

Extent

20. Extent refers to the quantity of a specific audit procedure to be performed, for example, a sample size or the number of observations of a control activity. The extent of an audit procedure is determined by the judgment of the auditor after considering the materiality, the assessed risk of material misstatement, and the degree of assurance the auditor plans to obtain. In particular, the auditor ordinarily increases the extent of audit procedures as the risk of material misstatement increases. However, increasing the extent of an audit procedure is effective only if the audit procedure itself is relevant to the specific risk and reliable; therefore, the nature of the audit procedure is the most important consideration.

21. The use of computer-assisted audit techniques (CAATs) enables extensive testing of electronic transactions and account files. Such techniques can be used to select sample transactions from key electronic files, to sort transactions with specific characteristics, or to test an entire population instead of a sample.

22. Valid conclusions may ordinarily be drawn using sampling approaches. However, if the sample size is too small, the sampling approach or the method of selection is not appropriate to achieve the specific audit objective, or exceptions are not appropriately followed up, there will be an unacceptable risk that the auditor's conclusion based on a sample may be different from the conclusion reached if the entire population was subjected to the same audit procedure. The proposed *SAS Amendment to Statement on Auditing Standards No. 39, Audit Sampling*, provides guidance on planning, performing, and evaluating audit samples.

23. This Statement regards the use of different audit procedures in combination as an aspect of the nature of testing as discussed above. However, the auditor should consider whether the extent of testing is appropriate when performing different audit procedures in combination.

Tests of Controls

24. The auditor must perform tests of controls when the auditor's risk assessment⁶ includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level.

25. When, in accordance with paragraph 118 of the proposed SAS *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement (Assessing Risks)*, the auditor has determined that it is not possible or practicable to reduce the risks of material misstatement at the relevant assertion level to an acceptably low level with audit evidence obtained only from substantive procedures, he or she should perform tests of controls to obtain audit evidence about their operating effectiveness. For example, as discussed in paragraph 121 of the proposed SAS *Assessing Risks*, the auditor may find it impossible to design effective substantive procedures that by themselves provide sufficient appropriate audit evidence at the relevant assertion level when an entity conducts its business using information technology (IT) and no documentation of transactions is produced or maintained, other than through the IT system.

26. Tests of the operating effectiveness of controls are performed only on those controls that the auditor has determined are suitably designed to prevent or detect a material misstatement in a relevant assertion. Paragraphs 107 through 109 of the proposed SAS *Assessing Risks* discuss the identification of controls at the relevant assertion level likely to prevent or detect a material misstatement in a class of transactions, account balance, or disclosure.

27. Testing the operating effectiveness of controls is different from obtaining audit evidence that controls have been implemented. When obtaining audit evidence of implementation by performing risk assessment procedures,⁷ the auditor should determine that the relevant controls exist and that the entity is using them. When performing tests of controls, the auditor should obtain audit evidence that controls operate effectively. This includes obtaining audit evidence about how controls were applied at relevant times during the period under audit, the consistency with which they were applied, and by whom or by what means they were applied. If substantially different controls were used at different times during the period under audit, the auditor should consider each separately. The auditor may determine that testing the operating effectiveness of controls at the same time as evaluating their design and obtaining audit evidence of their implementation is efficient.

28. Although some risk assessment procedures that the auditor performs to evaluate the design of controls and to determine that they have been implemented may not have been specifically designed as tests of controls, they may nevertheless provide audit evidence about the operating effectiveness of the controls and, consequently, serve as tests of controls. For example, because of the inherent consistency of IT processing, performing risk assessment procedures to determine whether an automated control has been implemented may serve as a test of that control's operating effectiveness, depending on such factors as whether the program has been changed or whether there is a significant risk of unauthorized change or other improper intervention. Also, in obtaining an understanding of the control environment, the auditor may have made inquiries about management's use of budgets, observed management's comparison of monthly budgeted and actual expenses, and inspected reports pertaining to the investigation of

⁶ The auditor's strategy reflects the level of assurance the auditor plans to obtain regarding controls.

⁷ Paragraph 6 of the proposed SAS *Assessing Risks* discusses the use of risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control, which the auditor uses to support assessments of the risks of material misstatement of the financial statements.

variances between budgeted and actual amounts. These audit procedures provide knowledge about the design of the entity's budgeting policies and whether they have been implemented, and may also provide audit evidence about the effectiveness of the operation of budgeting policies in preventing or detecting material misstatements in the classification of expenses. In such circumstances, the auditor should consider whether the audit evidence provided by those audit procedures is sufficient.

Nature of Tests of Controls

29. The auditor should select audit procedures to obtain assurance about the operating effectiveness of controls. As the planned level of assurance increases, the auditor should seek more reliable or more extensive audit evidence. In circumstances when the auditor adopts an approach consisting primarily of tests of controls, in particular related to those risks where it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures, the auditor should perform tests of controls to obtain a higher level of assurance about their operating effectiveness. Tests of the operating effectiveness of controls ordinarily include procedures such as inquiries of appropriate entity personnel; inspection of documents, reports, or electronic files, indicating performance of the control; observation of the application of the control; and reperformance of the application of the control by the auditor.

30. The auditor should perform other audit procedures in combination with inquiry to test the operating effectiveness of controls. Tests of the operating effectiveness of controls ordinarily include the same types of audit procedures used to evaluate the design and implementation of controls, and may also include reperformance of the application of the control by the auditor. Since inquiry alone is not sufficient, the auditor should use a combination of audit procedures to obtain sufficient appropriate audit evidence regarding the operating effectiveness of controls. Those controls subject to testing by performing inquiry combined with inspection or reperformance ordinarily provide more assurance than those controls for which the audit evidence consists solely of inquiry and observation. For example, an auditor may inquire about and observe the entity's procedures for opening the mail and processing cash receipts to test the operating effectiveness of controls over cash receipts. Because an observation is pertinent only at the point in time at which it is made, the auditor should supplement the observation with inquiries of entity personnel, and may also inspect documentation about the operation of such controls at other times during the audit period in order to obtain sufficient appropriate audit evidence.

31. The nature of the particular control influences the type of audit procedure necessary to obtain audit evidence about whether the control was operating effectively at relevant times during the period under audit. For some controls, operating effectiveness is evidenced by documentation. In such circumstances, the auditor may decide to inspect the documentation to obtain audit evidence about operating effectiveness. For other controls, however, such documentation may not be available or relevant. For example, documentation of operation may not exist for some factors in the control environment, such as assignment of authority and responsibility, or for some types of control activities, such as control activities performed by a computer. In such circumstances, audit evidence about operating effectiveness may be obtained through inquiry in combination with other audit procedures such as observation or the use of CAATs.

32. In designing tests of controls, the auditor should consider the need to obtain audit evidence supporting the effective operation of controls directly related to the relevant assertions as well as other indirect controls on which these controls depend. For example, the auditor may identify a user review of an exception report of credit sales over a customer's authorized credit limit as a direct control related to an assertion. In this case, the auditor should consider the

effectiveness of the user's review of the report and also the controls related to the accuracy of the information in the report (for example, the IT general and application controls).

33. In the case of an automated application control, because of the inherent consistency of IT processing, audit evidence about the implementation of the control, when considered in combination with audit evidence obtained regarding the operating effectiveness of the entity's IT general controls (and in particular, security and change controls), may provide substantial audit evidence about its operating effectiveness during the relevant period.

34. When responding to the risk assessment, the auditor may design a test of controls to be performed concurrently with a test of details on the same transaction. The objective of tests of controls is to evaluate whether a control operated effectively. The objective of tests of details is to support relevant assertions or detect material misstatements at the relevant assertion level. Although these objectives are different, both may be accomplished concurrently through performance of a test of controls and a test of details on the same transaction, known as a dual-purpose test. For example, the auditor may examine an invoice to determine whether it has been approved and to provide substantive evidence of a transaction. The auditor should carefully consider the design and evaluation of such tests in order to accomplish both objectives. Furthermore, when performing such tests the auditor should consider how the outcome of the tests of controls may affect the auditor's determination about the extent of substantive procedures to be performed. For example, if controls are found to be ineffective, the auditor should consider whether the sample size for substantive procedures should be increased from that originally planned.

35. The absence of misstatements detected by a substantive procedure does not provide audit evidence that controls related to the relevant assertion being tested are effective; however, misstatements that the auditor detects by performing substantive procedures should be considered by the auditor when assessing the operating effectiveness of related controls. A material misstatement detected by the auditor's procedures that was not identified by the entity ordinarily is indicative of the existence of a material weakness in internal control and should be communicated to management and those charged with governance.⁸

Timing of Tests of Controls

36. The timing of tests of controls depends on the auditor's objective and determines the period of reliance on those controls. If the auditor tests controls at a particular time, the auditor only obtains audit evidence that the controls operated effectively at that time. However, if the auditor tests controls throughout a period, the auditor should obtain audit evidence of the effectiveness of the operation of the controls during that period.

37. Audit evidence pertaining only to a point in time may be sufficient for the auditor's purpose, for example, when testing controls over the entity's physical inventory counting at the period end. If, on the other hand, the auditor needs audit evidence of the effectiveness of a control over a period, audit evidence pertaining only to a point in time may be insufficient and the auditor should supplement those tests with other tests of controls that are capable of providing audit evidence that the control operated effectively at relevant times during the period under audit. For example, for a control embedded in a computer program, the auditor may test the operation of the control at a particular point in time to obtain audit evidence about whether the control is operating effectively at that point in time. The auditor then may perform tests of controls directed toward obtaining audit evidence about whether the control operated consistently during the audit period, such as tests of general controls pertaining to the modification and use of that computer

⁸ See footnote 2 of the proposed SAS *Assessing Risks* for the definition of the term *those charged with governance*.

program during the audit period. Such additional tests may be made as part of the tests of controls over the entity's monitoring of controls.

38. When the auditor obtains audit evidence about the operating effectiveness of controls during an interim period, the auditor should determine what additional audit evidence should be obtained for the remaining period.

39. In making that determination, the auditor should consider the significance of the assessed risks of material misstatement at the relevant assertion level, the specific controls that were tested during the interim period, the degree to which audit evidence about the operating effectiveness of those controls was obtained, the length of the remaining period, the extent to which the auditor intends reduce further substantive procedures based on the reliance of controls, and the control environment. The auditor should obtain audit evidence about the nature and extent of any significant changes in internal control, including changes in the information system, processes, and personnel that occur subsequent to the interim period.

40. Additional audit evidence may be obtained, for example, by extending the testing of the operating effectiveness of controls over the remaining period, or testing the entity's monitoring of controls.

41. If the auditor plans to use audit evidence about the operating effectiveness of controls obtained in prior audits, the auditor should obtain audit evidence about whether changes in those specific controls have occurred subsequent to the prior audit. The auditor should obtain audit evidence about whether such changes have occurred by a combination of observation, inquiry, and inspection to confirm the understanding of those specific controls. Paragraph 24 of the proposed *SAS Audit Evidence* states that the auditor should perform audit procedures to establish the continuing relevance of audit evidence obtained in prior periods when the auditor plans to use such audit evidence in the current period. For example, in performing the prior audit, the auditor may have determined that an automated control was functioning as intended. The auditor should obtain audit evidence to determine whether changes to the automated control have been made that affect its continued effective functioning, for example, through inquiries of management and the inspection of logs to indicate whether controls have been changed. Consideration of audit evidence about these changes may support either increasing or decreasing the expected audit evidence to be obtained in the current period about the operating effectiveness of the controls.

42. If the auditor plans to rely on controls that have changed since they were last tested, the auditor should test the operating effectiveness of such controls in the current audit. Changes may affect the relevance of the audit evidence obtained in prior periods such that it may no longer be a basis for continued reliance. For example, changes in a system that enable an entity to receive a new report from the system probably do not affect the relevance of prior-period audit evidence; however, a change that causes data to be accumulated or calculated differently does affect it.

43. If, based on the understanding of the entity and its environment, the auditor plans to rely on controls that have not changed since they were last tested, the auditor should test the operating effectiveness of such controls at least once in every third audit. As indicated in paragraphs 41 and 46, the auditor may not rely on audit evidence about the operating effectiveness of controls obtained in prior audits for controls that have changed since they were last tested or for controls that mitigate a significant risk. The auditor's decision about whether to rely on audit evidence obtained in prior audits for other controls is a matter of professional judgment. In addition, the length of time period between retesting such controls is also a matter of professional judgment, but should not exceed more than two years. The auditor should test a control at least once in every third audit, because as time elapses between testing a control, the

audit evidence provided in the current audit period about the operating effectiveness of a control tested in a prior audit becomes less relevant and reliable (see paragraph 45).

44. In considering whether it is appropriate to use audit evidence about the operating effectiveness of controls obtained in prior audits and, if so, the length of the time period that may elapse before retesting a control, the auditor should consider:

- The effectiveness of other elements of internal control, including the control environment, the entity's monitoring of controls, and the entity's risk assessment process.
- The risks arising from the characteristics of the control, including whether controls are manual or automated (see paragraphs 57 through 63 of the proposed *SAS Assessing Risks* for a discussion of specific risks arising from manual and automated elements of a control).
- The effectiveness of IT general controls.
- The effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control from tests of operating effectiveness in prior audits.
- Whether the lack of a change in a particular control poses a risk due to changing circumstances.
- The risk of material misstatement and the extent of reliance on the control.

In general, the higher the risk of material misstatement, or the greater the reliance on controls, the shorter the time period elapsed, if any, is likely to be. Factors that ordinarily decrease the period for retesting a control, or result in not relying on audit evidence obtained in prior audits at all, include:

- A weak control environment.
- Weak monitoring controls.
- A significant manual element to the relevant controls.
- Personnel changes that significantly affect the application of the control.
- Changing circumstances that indicate the need for changes in the control.
- Weak IT general controls.

45. When there are a number of controls for which the auditor determines that it is appropriate to use audit evidence obtained in prior audits, the auditor should test the operating effectiveness of some controls each audit. The purpose of this standard is to avoid the possibility that the auditor might apply the approach of paragraph 43 to all controls on which the auditor proposes to rely, but test all those controls in a single audit period with no testing of controls in the subsequent two audit periods. In addition to providing audit evidence about the operating effectiveness of the controls being tested in the current audit, such tests provide collateral evidence about the continuing effectiveness of the control environment and therefore contribute to the decision about whether it is appropriate to rely on audit evidence obtained in prior audits. Therefore, when the auditor determines in accordance with paragraphs 41 through 44 that it is

appropriate to use audit evidence obtained in prior audits for a number of controls, the auditor should plan to test a sufficient portion of the controls in each audit period, so that at a minimum, each control is tested at least every third audit.

46. When, in accordance with paragraph 111 of the proposed SAS *Assessing Risks* the auditor has determined that an assessed risk of material misstatement at the relevant assertion level is a significant risk, and if the auditor plans to rely on the operating effectiveness of controls intended to mitigate that significant risk, the auditor should obtain audit evidence about the operating effectiveness of those controls from tests of controls performed in the current period. The greater the risk of material misstatement, the more audit evidence the auditor should obtain that controls are operating effectively. Accordingly, although the auditor often should consider information obtained in prior audits in designing tests of controls to mitigate a significant risk, the auditor should not rely on audit evidence about the operating effectiveness of controls over such risks obtained in a prior audit, but instead should obtain audit evidence about the operating effectiveness of controls over such risks in the current period.

Extent of Tests of Controls

47. The auditor should design sufficient tests of controls to obtain reasonable assurance that the controls are operating effectively throughout the period of reliance. Factors that the auditor may consider in determining the extent of tests of controls include the following:

- The frequency of the performance of the control by the entity during the period.
- The length of time during the audit period that the auditor is relying on the operating effectiveness of the control.
- The relevance and reliability of the audit evidence to be obtained in supporting that the control prevents, or detects and corrects, material misstatements at the relevant assertion level.
- The extent to which audit evidence is obtained from tests of other controls related to the relevant assertion.
- The extent to which the auditor plans to rely on the operating effectiveness of the control in the assessment of risk (and thereby reduce substantive procedures based on the reliance of such control).
- The expected deviation from the control.

Considering the above factors, when a control is applied on a transaction basis (for example, matching approved purchase orders to supplier invoices) and if the control operates frequently, the auditor should consider using an audit sampling technique to obtain reasonable assurance of the operation of the control. When a control is applied on a periodic basis (for example, monthly reconciliation of accounts receivable subsidiary ledger to the general ledger) the auditor should consider guidance appropriate for testing smaller populations (for example, testing the control application for two months and reviewing evidence the control operated in other months or reviewing other months for unusual items). Refer further to SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350), and the related Audit Guide.

48. To reduce the extent of substantive procedures in an audit, the tests of controls performed by the auditor need to be sufficient to determine the operating effectiveness of the controls at the relevant assertion level and the level of planned reliance (see paragraph 51).

49. The more the auditor relies on the operating effectiveness of controls in the assessment of risk, the greater is the extent of the auditor's tests of controls. In addition, as the rate of expected deviation from a control increases, the auditor should increase the extent of testing of the control. However, the auditor should consider whether the rate of expected deviation indicates that obtaining audit evidence from the performance of tests of controls will not be sufficient to reduce the risk of material misstatement at the relevant assertion level. If the rate of expected deviation is expected to be too high, the auditor may determine that tests of controls for a particular assertion may not be effective.

50. Generally, IT processing is inherently consistent; therefore, the auditor may be able to limit the testing to one or a few instances of the control operation. An automated control should function consistently unless the program (including the tables, files, or other permanent data used by the program) is changed. Once the auditor determines that an automated control is functioning as intended (which could be done at the time the control is initially implemented or at some other date), the auditor should perform tests to determine that the control continues to function effectively. Such tests might include determining that changes to the program are not made without being subject to the appropriate program change controls, that the authorized version of the program is used for processing transactions, and that other relevant general controls are effective. Such tests also might include determining that changes to the programs have not been made, as may be the case when the entity uses packaged software applications without modifying or maintaining them. For example, the auditor may inspect the administration of IT security to obtain audit evidence that unauthorized access has not occurred during the period.

Substantive Procedures

51. Substantive procedures are performed to detect material misstatements at the relevant assertion level, and include tests of details of classes of transactions, account balances, and disclosures and substantive analytical procedures. The auditor should plan and perform substantive procedures to be responsive to the related assessment of the risk of material misstatement.

52. Regardless of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. This reflects the fact that the auditor's assessment of risk is judgmental and may not be sufficiently precise to identify all risks of material misstatement. Further, there are inherent limitations to internal control, including management override, and even effective internal controls generally reduce, but do not eliminate, the risk of material misstatement. Accordingly, while the auditor may determine that the risk of material misstatement may be reduced to an acceptably low level by performing only tests of controls for a particular assertion related to a class of transactions, account balance, or disclosure (see paragraph 8), the auditor should perform substantive procedures for each material class of transactions, account balance, and disclosure.

53. The auditor's substantive procedures should include the following audit procedures related to the financial statement reporting system:

- Agreeing the financial statements, including their accompanying notes, to the underlying accounting records; and
- Examining material journal entries and other adjustments made during the course of preparing the financial statements.

The nature and extent of the auditor's examination of journal entries and other adjustments depend on the nature and complexity of the entity's financial reporting system and the associated risks of material misstatement.

54. When, in accordance with paragraph 111 of the proposed *SAS Assessing Risks*, the auditor has determined that an assessed risk of material misstatement at the relevant assertion level is a significant risk, the auditor should perform substantive procedures that are specifically responsive to that risk. For example, if the auditor identifies that management is under pressure to meet earnings expectations, there may be a risk that management is inflating sales by improperly recognizing revenue related to sales agreements with terms that preclude revenue recognition or by invoicing sales before shipment. In these circumstances, the auditor may, for example, design external written confirmations not only to confirm outstanding amounts, but also to confirm the details of the sales agreements, including date, any rights of return, and delivery terms. In addition, the auditor may find it effective to supplement such external written confirmations with inquiries of nonfinancial personnel in the entity regarding any changes in sales agreements and delivery terms.

55. When the approach to significant risks consists only of substantive procedures, the audit procedures appropriate to address such significant risks consist of tests of details only, or a combination of tests of details and substantive analytical procedures. The auditor should consider the guidance in paragraphs 56 through 69 in designing the nature, timing, and extent of substantive procedures for significant risks. To obtain sufficient appropriate audit evidence, the substantive procedures related to significant risks are most often designed to obtain audit evidence with higher reliability. For significant risks of material misstatement, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.

Nature of Substantive Procedures

56. Substantive procedures include tests of details and substantive analytical procedures. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. Tests of details are ordinarily more appropriate to obtain audit evidence regarding certain relevant assertions about account balances, including existence and valuation. The auditor should plan substantive procedures to be responsive to the assessed risk of material misstatement. In some situations, the auditor may determine that performing only substantive analytical procedures may be sufficient to reduce the risk of material misstatement to an acceptably low level. For example, the auditor may determine that performing only substantive analytical procedures is responsive to the assessed risk of material misstatement for an individual class of transactions where the auditor's assessment of risk has been reduced by obtaining audit evidence from performance of tests of the operating effectiveness of controls. In other situations, the auditor may determine that tests of details only are appropriate, or that a combination of substantive analytical procedures and tests of details is most responsive to the assessed risks. The auditor's determination as to the substantive procedures that are most responsive to the assessed risk of material misstatement is affected by whether the auditor has obtained audit evidence about the operating effectiveness of controls. The Appendix includes examples of substantive procedures that may be performed on inventories of a manufacturing entity.

57. The auditor should design tests of details responsive to the assessed risk with the objective of obtaining sufficient appropriate audit evidence to achieve the planned level of assurance at the relevant assertion level. In designing substantive procedures related to the existence or occurrence assertion, the auditor should select from items contained in a financial statement amount and should obtain the relevant audit evidence. On the other hand, in designing audit procedures related to the completeness assertion, the auditor should select from audit evidence indicating that an item should be included in the relevant financial statement amount and investigates whether that item is so included. The knowledge gained when understanding the

business and its environment should be helpful in selecting the nature, timing, and extent of audit procedures related to the completeness assertion. For example, the auditor might inspect subsequent cash disbursements and compare them with the recorded accounts payable to determine whether any purchases had been omitted from accounts payable.

58. In designing substantive analytical procedures, the auditor should consider such matters as:

- The suitability of using substantive analytical procedures, given the assertions
- The reliability of the data, whether internal or external, from which the expectation of recorded amounts or ratios is developed
- Whether the expectation is sufficiently precise to identify the possibility of a material misstatement at the desired level of assurance
- The amount of any difference in recorded amounts from expected values that is acceptable

The auditor should consider testing the controls, if any, over the entity's preparation of information to be used by the auditor in applying analytical procedures. When such controls are effective, the auditor has greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. When designing substantive analytical procedures, the auditor should evaluate the risk of management override of controls. As part of this process, the auditor should evaluate whether such an override might have allowed adjustments outside of the normal period end financial reporting process to have been made to the financial statements. Such adjustments might have resulted in artificial changes to the financial statement relationships being analyzed, causing the auditor to draw erroneous conclusions. For this reason, substantive analytical procedures alone are not well suited to detecting some types of fraud. Alternatively, the auditor may consider whether the information was subjected to audit testing in the current or prior period. In determining the audit procedures to apply to the information upon which the expectation for substantive analytical procedures is based, the auditor should consider the guidance in paragraph 15.

Timing of Substantive Procedures

59. In some circumstances, substantive procedures may be performed at an interim date. When substantive procedures are performed at an interim date, the auditor should perform further substantive procedures or substantive procedures combined with tests of controls to cover the remaining period that provide a reasonable basis for extending the audit conclusions from the interim date to the period end.

60. Performing substantive procedures at an interim date increases the risk that misstatements that may exist at the period end are not detected by the auditor. This risk increases as the remaining period is lengthened. In considering whether to perform substantive procedures at an interim date, the auditor should consider such factors as:

- The control environment and other relevant controls
- The availability of information at a later date that is necessary for the auditor's procedures
- The objective of the substantive procedure
- The assessed risk of material misstatement

- The nature of the class of transactions or account balance and relevant assertions
- The ability of the auditor to reduce the risk that misstatements that exist at the period end are not detected by performing appropriate substantive procedures or substantive procedures combined with tests of controls to cover the remaining period in order to reduce the risk that misstatements that exist at period end are not detected

61. Although it is not necessary to obtain audit evidence about the operating effectiveness of controls in order to have a reasonable basis for extending audit conclusions from an interim date to the period end, the auditor should consider whether performing only substantive procedures to cover the remaining period is sufficient. If the auditor concludes that substantive procedures alone would not be sufficient to cover the remaining period, tests of the operating effectiveness of relevant controls should be performed or the substantive procedures should be performed as of the period end.

62. In circumstances where the auditor has identified risks of material misstatement due to fraud, the auditor's responses to address those risks may include changing the timing of audit procedures. For example, the auditor might conclude that, given the risks of intentional misstatement or manipulation, audit procedures to extend audit conclusions from an interim date to the period-end reporting date would not be effective. In such circumstances, the auditor might conclude that substantive procedures should be performed at or near the end of the reporting period to best address an identified risk of material misstatement due to fraud.⁹

63. When performing substantive procedures at an interim date, the auditor ordinarily compares and reconciles information concerning the balance at the period end with the comparable information at the interim date to identify amounts that appear unusual, investigates any such amounts, and performs substantive analytical procedures or tests of details to test the intervening period. When the auditor plans to perform substantive analytical procedures with respect to the intervening period, the auditor should consider whether the period-end balances of the particular classes of transactions or account balances are reasonably predictable with respect to amount, relative significance, and composition. The auditor should also consider whether the entity's procedures for analyzing and adjusting such classes of transactions or account balances at interim dates and for establishing proper accounting cutoffs are appropriate. In addition, the auditor should consider whether the information system relevant to financial reporting will provide information concerning the balances at the period end and the transactions in the remaining period that is sufficient to permit investigation of (a) significant unusual transactions or entries (including those at or near the period end); (b) other causes of significant fluctuations, or expected fluctuations that did not occur; and (c) changes in the composition of the classes of transactions or account balances.

64. If misstatements are detected in classes of transactions or account balances at an interim date, the auditor should consider modifying the related assessment of risk and the planned nature, timing, or extent of the substantive procedures covering the remaining period that relate to such classes of transactions or account balances, or the auditor extends or repeats such audit procedures at the period end.

65. The use of audit evidence from the performance of substantive procedures in a prior audit is not sufficient to address a risk of material misstatement in the current period. In most cases, audit evidence from the performance of substantive procedures in a prior audit provides little or no audit evidence for the current period. In order for audit evidence obtained in a prior audit to be used in the current period as substantive audit evidence, the audit evidence and the

⁹ See SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316.52).

related subject matter must not fundamentally change. An example of audit evidence obtained from the performance of substantive procedures in a prior period that may be relevant in the current year is a legal opinion related to the structure of a securitization to which no changes have occurred during the current period. As specified by paragraph 24 of the proposed SAS *Audit Evidence*, if the auditor plans to use audit evidence obtained from the performance of substantive procedures in a prior audit, the auditor should perform audit procedures during the current period to establish the continuing relevance of the audit evidence.

66. The timing of audit procedures also involves consideration of whether related audit procedures are properly coordinated. This includes, for example:

- a. Coordinating the audit procedures applied to related-party transactions and balances.¹⁰
- b. Coordinating the testing of interrelated accounts and accounting cutoffs.
- c. Maintaining temporary audit control over assets that are readily negotiable and simultaneously testing such assets and cash on hand and in banks, bank loans, and other related items.

Decisions about coordinating related audit procedures should be made in the light of the risks of material misstatement and of the particular audit procedures that could be applied, either for the remaining period or at period end, or both.

Extent of the Performance of Substantive Procedures

67. The greater the risk of material misstatement, the greater the extent of substantive procedures. Because the risk of material misstatement includes consideration of the effectiveness of internal control, the extent of substantive procedures may be reduced by satisfactory results from tests of the operating effectiveness of controls. However, increasing the extent of an audit procedure is appropriate only if the audit procedure itself is relevant to the specific risk.

68. In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size, which is affected by the risk of material misstatement, tolerable misstatement, expected misstatement, and nature of the population. However, the auditor should also consider other matters, including whether it is more effective to use other selective means of testing, such as selecting large or unusual items from a population as opposed to performing sampling or stratifying the population into homogeneous sub-populations for sampling. The proposed SAS *Audit Sampling* contains guidance on the use of sampling and other means of selecting items for testing.

69. In designing substantive analytical procedures, the auditor should consider the amount of difference from the expectation that can be accepted without further investigation. This consideration is influenced primarily by materiality and should be consistent with the desired level of assurance. Determination of this amount involves considering the possibility that a combination of misstatements in the specific account balance, class of transactions, or disclosure could aggregate to an unacceptable amount. In designing substantive analytical procedures, the auditor should increase the desired level of assurance as the risk of material misstatement increases. SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329), contains guidance on the application of analytical procedures during an audit.

¹⁰ See SAS No. 45, *Related Parties* (AICPA, *Professional Standards*, vol. 1, AU sec. 334).

Adequacy of Presentation and Disclosure

70. The auditor should perform audit procedures to evaluate whether the overall presentation of the financial statements, including the related disclosures, are in accordance with generally accepted accounting principles. The auditor should consider whether the individual financial statements are presented in a manner that reflects the appropriate classification and description of financial information. The presentation of financial statements in conformity with generally accepted accounting principles also includes adequate disclosure of material matters. These matters relate to the form, arrangement, and content of the financial statements and their related notes, including, for example, the terminology used, the amount of detail given, the classification of items in the financial statements, and the bases of amounts set forth. The auditor should consider whether management should have disclosed a particular matter in light of the circumstances and facts of which the auditor is aware at the time. In performing the evaluation of the overall presentation of the financial statements, including the related disclosures, the auditor should consider the assessed risk of material misstatement at the relevant assertion level. See paragraph 15 of the proposed *SAS Audit Evidence* for a description of the relevant assertions related to presentation and disclosure.

EVALUATING THE SUFFICIENCY AND APPROPRIATENESS OF THE AUDIT EVIDENCE OBTAINED¹¹

71. Based on the audit procedures performed and the audit evidence obtained, the auditor should evaluate whether the assessments of the risks of material misstatement at the relevant assertion level remain appropriate.

72. An audit of financial statements is a cumulative and iterative process. As the auditor performs planned audit procedures, the audit evidence obtained may cause the auditor to modify the nature, timing, or extent of other planned audit procedures. Information may come to the auditor's attention that differs significantly from the information on which the risk assessments were based. For example, the extent of misstatements that the auditor detects by performing substantive procedures may alter the auditor's judgment about the risk assessments and may indicate a material weakness in internal control. In addition, analytical procedures performed at the overall review stage of the audit may indicate a previously unrecognized risk of material misstatement (see SAS No. 56). In such circumstances, the auditor should reevaluate the planned audit procedures based on the revised consideration of assessed risks for all or some of the classes of transactions, account balances, or disclosures and relevant assertions. Paragraph 122 of the proposed *SAS Assessing Risks* contains further guidance on revising the auditor's risk assessment.

73. The concept of effectiveness of the operation of controls recognizes that some deviations in the way controls are applied by the entity may occur. Deviations from prescribed controls may be caused by such factors as changes in key personnel, significant seasonal fluctuations in volume of transactions, and human error. When such deviations are detected during the performance of tests of controls, the auditor should make specific inquiries to understand these matters and their potential consequences, for example, by inquiring about the timing of personnel changes in key internal control functions. In addition, the auditor should consider whether any misstatements detected from the performance of substantive procedures alter the auditor's judgment as to the effectiveness of the related controls. The auditor should determine whether the tests of controls performed provide an appropriate basis for reliance on the controls, whether additional tests of controls are necessary, or whether the potential risks of misstatement need to be addressed using substantive procedures.

¹¹ See paragraph 65 of the proposed *SAS Audit Risk and Materiality*.

74. The auditor should not assume that an instance of fraud or error is an isolated occurrence, and therefore should consider how the detection of such misstatement affects the assessed risks of material misstatement. Before the conclusion of the audit, the auditor should evaluate whether audit risk has been reduced to an appropriately low level and whether the nature, timing, and extent of the audit procedures may need to be reconsidered. For example, the auditor should reconsider:

- The nature, timing, and extent of substantive procedures
- The audit evidence of the operating effectiveness of relevant controls, including the entity's risk assessment process

75. The auditor should conclude whether sufficient appropriate audit evidence has been obtained to reduce to an appropriately low level the risk of material misstatement in the financial statements. In developing an opinion, the auditor should consider all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the relevant assertions in the financial statements.

76. The sufficiency and appropriateness of audit evidence to support the auditor's conclusions throughout the audit are a matter of professional judgment. The auditor's judgment as to what constitutes sufficient appropriate audit evidence is influenced by such factors as the:

- Significance of the potential misstatement in the relevant assertion and the likelihood of its having a material effect, individually or aggregated with other potential misstatements, on the financial statements.
- Effectiveness of management's responses and controls to address the risks.
- Experience gained during previous audits with respect to similar potential misstatements.
- Results of audit procedures performed, including whether such audit procedures identified specific instances of fraud or error.
- Source and reliability of available information.
- Persuasiveness of the audit evidence.
- Understanding of the entity and its environment, including its internal control.

77. If the auditor has not obtained sufficient appropriate audit evidence as to a material financial statement assertion, the auditor should attempt to obtain further audit evidence. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor should express a qualified opinion or a disclaimer of opinion.¹²

DOCUMENTATION

78. The auditor should document:

¹² See SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508.20–.34 and .61–.63), as amended, for further guidance on expression of a qualified opinion or a disclaimer of opinion.

- a. The overall responses to address the assessed risks of misstatement at the financial statement level
- b. The nature, timing, and extent of the further audit procedures
- c. The linkage of those procedures with the assessed risks at the relevant assertion level
- d. The results of the audit procedures
- e. The conclusions reached with regard to the use in the current audit of audit evidence about the operating effectiveness of controls that was obtained in a prior audit

The manner in which these matters are documented is based on the auditor's professional judgment. SAS No. 96, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), establishes standards and provides guidance regarding documentation in the context of the audit of financial statements.

EFFECTIVE DATE

79. This Statement is effective for audits of financial statements for periods beginning on or after December 15, 2006. Earlier application is permitted.

Appendix

Illustrative Financial Statement Assertions and Examples of Substantive Procedures Illustrations for Inventories of a Manufacturing Company

A.1 This appendix illustrates the use of assertions in designing substantive procedures and does not illustrate tests of controls. The following examples of substantive procedures are not intended to be all-inclusive, nor is it expected that all of the procedures would be applied in an audit. The particular substantive procedures to be used in each circumstance depend on the auditor's risk assessments and tests of controls.

Illustrative Assertions About Account Balances

Examples of Substantive Procedures

Existence

Inventories included in the balance sheet physically exist.

- Physical examination of inventory items.
- Obtaining confirmation of inventories at locations outside the entity.
- Inspection of documents relating to inventory transactions between a physical inventory date and the balance sheet date.
- Inspecting perpetual inventory records, production records, and purchasing records for indications of current activity.
- Reconciling items in the inventory listing to a current computer-maintained sales catalog and subsequent sales and delivery reports using computer-assisted audit techniques (CAATs).
- Inquiry of production and sales personnel.
- Using the work of specialists to corroborate the nature of specialized products.

Inventories represent items held for sale or use in the normal course of business.

Rights and Obligations

The entity has legal title or similar rights of ownership to the inventories.

- Physical examination of inventory items.
- Obtaining confirmation of inventories at locations outside the entity.
- Examining paid vendors' invoices, consignment agreements, and contracts.
- Examining unpaid vendors' invoices, consignment agreements, and contracts.
- Inspecting shipping and receiving transactions near year end for recording in the proper period.

Inventories exclude items billed to customers or owned by others.

Completeness

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

- Observing physical inventory counts.
- Analytically comparing the relationship of inventory balances to recent purchasing, production, and sales activities.
- Inspecting shipping and receiving transactions near year end for recording in the proper period.
- Obtaining confirmation of inventories at locations outside the entity.

Inventory quantities include all products, materials, and supplies owned by the company that are in transit or stored at outside locations.

Illustrative Assertions About Account Balances
Completeness

Inventory listings are accurately compiled and the totals are properly included in the inventory accounts.

Valuation and Allocation

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.

Illustrative Assertions About Presentation and
Disclosure

Rights and Obligations

The pledge or assignment of any inventories is appropriately disclosed.

Completeness

The financial statements include all disclosures

- Analytically comparing the relationship of inventory balances to recent purchasing, production, and sales activities.

Examples of Substantive Procedures

- Inspecting shipping and receiving transactions near year end for recording in the proper period.
- Examining the inventory listing for inclusion of test counts recorded during the physical inventory observation.
- Reconciliation of all inventory tags and count sheets used in recording the physical inventory counts using CAATs.
- Recalculation of inventory listing for clerical accuracy using CAATs.
- Reconciling physical counts to perpetual records and general ledger balances and investigating significant fluctuations using CAATs.

- Examining paid vendors' invoices and comparing product prices to standard cost build-ups.
- Analytically comparing direct labor rates to production records.
- Recalculation of the computation of standard overhead rates.
- Examining analyses of purchasing and manufacturing standard cost variances.
- Examining an analysis of inventory turnover.

- Analyzing industry experience and trends.
- Analytically comparing the relationship of inventory balances to anticipated sales volume.
- Walk-through of the plant for indications of products not being used.
- Inquiring of production and sales personnel concerning possible excess, defective, or obsolete inventory items.
- Logistic and distribution business process (e.g., cycle time, volume of returns, or problems with suppliers)
- Inspecting sales catalogs or industry publications for current market value quotations.
- Recalculation of inventory valuation reserves.
- Analyzing current production costs.
- Examining sales after year end and open purchase order commitments.

Examples of Substantive Procedures

- Obtaining confirmation of inventories pledged under loan agreements.
- Using a disclosure checklist to determine

related to inventories specified by generally accepted accounting principles.

Understandability

Inventories are properly classified in the balance sheet as current assets.

Disclosures related to inventories are understandable.

whether the disclosures included in generally accepted accounting principles were made.

- Examining drafts of the financial statements for appropriate balance sheet classification.
- Reading disclosures for clarity.

Illustrative Assertions About Presentation and Disclosure

Accuracy and Valuation

The major categories of inventories and their bases of valuation are accurately disclosed in the financial statements.

Examples of Substantive Procedures

- Examining drafts of the financial statements for appropriate disclosures.
- Reconciling the categories of inventories disclosed in the draft financial statements to the categories recorded during the physical inventory observation.