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Companion to PPC's Guide to

Audit Risk Assessment

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Interactive Self-study CPE

Companion to PPC's Guide to Audit Risk Assessment

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INTRODUCTION

Companion to PPC's Guide to Audit Risk Assessment consists of one interactive self-study CPE course. This is a companion course to *PPC's Guide to Audit Risk Assessment* designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **cl.thomsonreuters.com/ogs** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **October 31, 2018**. Complete instructions for grading are included below and in the Test Instructions preceding the Examination for CPE Credit.

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This course is divided into lessons. Each lesson addresses an aspect of audit risk assessment. You are asked to read the material and, during the course, to test your comprehension of each of the learning objectives by answering self-study quiz questions. After completing each quiz, you can evaluate your progress by comparing your answers to both the correct and incorrect answers and the reason for each. References are also cited so you can go back to the text where the topic is discussed in detail. Once you are satisfied that you understand the material, **answer the examination questions at the end of the course**. You may record your answer choices by printing the **Examination for CPE Credit Answer Sheet** or by logging on to our Online Grading System.

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Checkpoint Learning is also approved for "QAS Self Study" designation.

The requirements for NASBA Registry membership include conformance with the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. Each course is designed to comply with the *Standards*. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*. Credit hours for CPE courses vary in length. Credit hours for each course are listed on the **Overview** page before each course.

CPE requirements are established by each state. You should check with your state board of accountancy to determine the acceptability of this course. We have been informed by the North Carolina State Board of Certified Public Accountant Examiners and the Mississippi State Board of Public Accountancy that they will not allow credit for courses included in books or periodicals.

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You may fax your completed **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation** to **(888) 286-9070** or email them to *CPLGrading@thomsonreuters.com*. The mailing address is provided on the Overview and Exam Instructions pages.

If more than one person wants to complete this self-study course, each person should complete a separate **Examination for CPE Credit Answer Sheet.** Payment must accompany each answer sheet submitted ($89 when sent by email or fax; $99 when sent by regular mail). We would also appreciate a separate **Self-study Course Evaluation** from each person who completes an examination.

Retaining CPE Records

For all scores of 70% or higher, you will receive a *Certificate of Completion.* You should retain it and a copy of these materials for at least five years.

COMPANION TO PPC'S GUIDE TO AUDIT RISK ASSESSMENT

COURSE 1

ASSESSING AND RESPONDING TO IDENTIFIED RISKS, FURTHER AUDIT PROCEDURES, AND OTHER MATTERS (GRATG171)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course examines two important topics related to audit risk assessment. Lesson 1 takes a look at developing a detailed audit plan, which includes assessing and responding to identified fraud risks. The topics covered in this lesson include performance materiality, financial statement assertions, synthesis, assessing risks of material misstatement at the relevant assertion level, and the PPC audit approach that can be used to prepare the detailed audit plan. Lesson 2 discusses further audit procedures and other matters. The topics covered include tests of controls, evaluating tests of controls, assessing control risk, and performing substantive procedures.
PUBLICATION/REVISION DATE:	November 2017
RECOMMENDED FOR:	Users of *PPC's Guide to Audit Risk Assessment*
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of auditing
CPE CREDIT:	8 NASBA Registry "QAS Self-Study" Hours This course is designed to meet the requirements of the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*.
FIELD OF STUDY:	Auditing
EXPIRATION DATE:	Postmark by **October 31, 2018**
KNOWLEDGE LEVEL:	Basic

Learning Objectives:

Lesson 1—Assessing and Responding to Identified Fraud Risks—Developing the Detailed Audit Plan

Completion of this lesson will enable you to:
- Identify an appropriate approach to performance materiality, and the concept of financial statement assertions.
- Identify ways to synthesize information to identify risks of material misstatement at the relevant assertion level and then assess those risks.
- Recognize a practical approach to preparing a detailed audit plan for the engagement.

Lesson 2—Further Audit Procedures and Other Matters

Completion of this lesson will enable you to:
- Determine the appropriate procedures for tests of controls.

- Recognize how to evaluate tests of controls and assess control risks.
- Identify the best methods for dealing with substantive procedures.

TO COMPLETE THIS LEARNING PROCESS:

Log onto our Online Grading Center at **cl.thomsonreuters.com/ogs.** Online grading allows you to get instant CPE credit for your exam.

Alternatively, you can submit your completed **Examination for CPE Credit Answer Sheet, Self-study Course Evaluation,** and payment via one of the following methods:

- Email to: *CPLGrading@thomsonreuters.com*
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- Mail to:

Thomson Reuters
Tax & Accounting—Checkpoint Learning
GRATG171 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700

See the test instructions included with the course materials for additional instructions and payment information.

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 431-9025 for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: Assessing and Responding to Identified Fraud Risks—Developing the Detailed Audit Plan

INTRODUCTION

This lesson focuses on (a) assessing the risks identified by the auditor throughout the process of performing risk assessment procedures and (b) selecting responses that are appropriate to address those risks. The result of the auditor's risk assessment is the preparation of a detailed audit plan describing the nature, timing, and extent of further audit procedures.

Auditing procedures consist of two broad categories: (a) risk assessment procedures and (b) further audit procedures. A detailed discussion of the risk assessment procedures that are performed to obtain an understanding of the entity and its environment is beyond the scope of this course, but more information is available in *PPC's Guide to Audit Risk Assessment*. This understanding is used to establish an overall audit strategy, and a detailed audit plan describing the nature, timing, and extent of further audit procedures. The detailed audit plan is the subject of this lesson.

The audit decisions and judgments made when developing the detailed audit plan are as follows:

a. Determine performance materiality for particular classes of transactions, account balances, or disclosures.

b. Identify the risks of material misstatement of the financial statements by synthesizing information gathered about the entity and its environment throughout the process of performing risk assessment procedures.

c. Assess the risks of material misstatement at the relevant assertion level related to particular transaction classes, account balances, and disclosures.

d. Select further audit procedures responsive to the risks of material misstatement at the relevant assertion level. Further audit procedures include the following:

    (1) Tests of controls.

    (2) Substantive procedures.

The identification and assessment of risks, as well as the selection of further audit procedures, requires an understanding of financial statement assertions, which are discussed later in this lesson. Tests of controls and substantive procedures are discussed more fully in Lesson 2.

Learning Objectives:

Completion of this lesson will enable you to:
- Identify an appropriate approach to performance materiality, and the concept of financial statement assertions.
- Identify ways to synthesize information to identify risks of material misstatement at the relevant assertion level and then assess those risks.
- Recognize a practical approach to preparing a detailed audit plan for the engagement.

AUTHORITATIVE LITERATURE

The following standards establish key requirements and provide guidance that affects assessing risks and developing the detailed audit plan:

- AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, establishes requirements for identifying and assessing the risks of material misstatement due to fraud at the assertion level.

- AU-C 300, *Planning an Audit*, establishes requirements for developing and updating an audit plan.

- AU-C 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, establishes requirements for identifying, assessing, and revising the risks of material misstatement at the assertion level and explains the concept of assertions.

- AU-C 320, *Materiality in Planning and Performing an Audit*, establishes requirements for determining materiality for the financial statements as a whole and performance materiality as a basis for assessing the risks of material misstatements at the assertion level, and determining the nature, timing, and extent of further audit procedures.

- AU-C 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, establishes requirements for designing and performing further audit procedures responsive to risks of material misstatement at the relevant assertion level.

- AU-C 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, establishes requirements for auditing estimates.

- AU-C 550, *Related Parties*, establishes requirements regarding related party relationships and transactions.

Exhibit 1-1 summarizes the requirements related to assessing risks and preparing the detailed audit plan as part of audit planning.

Exhibit 1-1

Requirements Related to Assessing Risks and Developing the Detailed Audit Plan

Requirements	**AU-C Reference**
Materiality in Planning and Performing an Audit	
Determine performance materiality to be used to assess the risks of material misstatement and determine the nature, timing, and extent of further audit procedures.	AU-C 320.11
Document performance materiality and any revisions during the audit to that amount.	AU-C 320.14
Planning an Audit	
Develop an audit plan that includes the nature and extent of planned risk assessment procedures; the nature, timing, and extent of planned further audit procedures at the relevant assertion level; and any other planned audit procedures that should be performed.	AU-C 300.09
Update and modify the overall audit strategy and the audit plan, as necessary, throughout the engagement.	AU-C 300.10
Document the overall audit strategy, the audit plan, any significant changes made during the engagement to the audit strategy or the audit plan, and the reasons for those changes.	AU-C 300.14
Assessing the Risks of Material Misstatement	
Identify and assess the risks of material misstatement at the financial statement and relevant assertion level for classes of transactions, account balances, and presentation and disclosures.	AU-C 315.26
When identifying and assessing the risks of material misstatement: • Identify risks while understanding the entity and its environment, including relevant controls that relate to the risks, by considering the classes of transactions, account balances, and disclosures in the financial statements. • Assess identified risks and consider if they are pervasive to the financial statements as a whole and potentially affect many assertions.	AU-C 315.27

Requirements	AU-C Reference
• Relate the identified risks to what can go wrong at the relevant assertion level, considering relevant controls that are expected to be tested. • Consider the likelihood of misstatement(s) and whether the potential misstatement(s) could result in a material misstatement.	
Determine whether any of the identified risks are a significant risk without considering the effects of any relevant identified controls. In making this determination, consider whether— • The risk is a fraud risk. • The risk is related to recent significant economic, accounting, or other developments requiring specific attention. • The transactions are complex. • The risk involves significant transactions with related parties. • The measurement of the financial information related to the risk is subjective and involves a wide range of uncertainty. • The risk involves significant unusual transactions or those outside the normal course of business.	AU-C 315.28–.29
If a significant risk exists, obtain an understanding of the controls related to that risk and, based on that understanding, evaluate whether the controls are suitably designed and implemented to mitigate such risks.	AU-C 315.30
For risks where it is not possible or practicable to obtain sufficient appropriate evidence from only substantive procedures, obtain an understanding of the controls over such risks.	AU-C 315.31
Document: • Identified and assessed risks of material misstatement at the financial statement level and at the relevant assertion level. • Significant risks and risks for which substantive procedures alone are not sufficient and the understanding obtained of the related controls.	AU-C 315.33
Consideration of Fraud in a Financial Statement Audit	
Identify and assess the risks of material misstatement due to fraud at the financial statement level and at the assertion level for classes of transactions, account balances, and disclosures.	AU-C 240.25
Evaluate (based on the presumption that revenue recognition is a fraud risk) which types of revenue, revenue transactions, or assertions give rise to risk of material misstatement due to fraud.	AU-C 240.26
Document the following: • The significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud, how and when the discussion occurred, and the audit team members who participated. • The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level.	AU-C 240.43
Document the following as part of the auditor's responses to the assessed risks of material misstatement: • The overall responses to the assessed risks of material misstatement due to fraud at the financial statement level; the nature, timing, and extent of audit procedures; and the linkage of those procedures with the assessed risks of material misstatement due to fraud at the assertion level. • The results of the audit procedures, including those designed to address the risk of management override of controls.	AU-C 240.44

Requirements	AU-C Reference
Document how the presumption that improper revenue recognition is a fraud risk was overcome, if applicable.	AU-C 240.46
Performing Audit Procedures in Response to Assessed Risks	
Design and perform further audit procedures whose nature, timing, and extent are responsive to risks of material misstatement at the relevant assertion level.	AU-C 330.06
When designing further audit procedures: • Consider the reasons for the risk assessment at the relevant assertion level for each transaction class, account balance, and disclosure, including inherent risk and control risk. • Obtain more persuasive audit evidence the higher the risk assessment.	AU-C 330.07
When reliance on controls over a significant risk is planned, test the operating effectiveness of those controls in the current period.	AU-C 330.15
Regardless of the assessed risks of material misstatement, design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure.	AU-C 330.18
When there are significant risks at the relevant assertion level, perform substantive procedures specifically responsive to the risks, including tests of details when the response consists of only substantive procedures.	AU-C 330.22
Document the following: • Overall responses to address risks of material misstatement at the financial statement level and the nature, timing, and extent of further audit procedures performed. • The linkage of further audit procedures with assessed risks at the relevant assertion level. • The results of audit procedures, including conclusions that are not otherwise clear.	AU-C 330.30
Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures	
Evaluate the degree of estimation uncertainty associated with an accounting estimate as part of identifying and assessing the risk of material misstatement. Determine whether any estimations having a high degree of estimation uncertainty represent significant risks.	AU-C 540.10–.11
Determine whether management has appropriately applied GAAP to the accounting estimate, whether the method for making the estimate is appropriate and applied consistently, and whether any change in the estimate or method from the prior period is appropriate.	AU-C 540.12
Related Parties	
Identify and assess the risks of material misstatement associated with related party relationships and transactions to determine whether they represent significant risks.	AU-C 550.19
Consider any identified related party fraud risk factors in identifying and assessing risks of material misstatement due to fraud.	AU-C 550.20

*   *   *

DETERMINING PERFORMANCE MATERIALITY

The auditor's objective is to perform the audit to obtain reasonable assurance of detecting misstatements that the auditor believes could be large enough, individually or in the aggregate, to be quantitatively material to the financial statements. For this purpose, the auditor needs to establish a performance materiality amount(s) at the individual account balance, class of transaction, or disclosure level.

Performance materiality is the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. When applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level(s) for particular classes of transactions, account balances, or disclosures. AU-C 320.11 states that the auditor should determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing, and extent of further audit procedures.

Performance materiality is distinguishable from tolerable misstatement. As explained in AU-C 320.A2, the application of performance materiality to a particular audit sampling procedure is called *tolerable misstatement*. AU-C 530.A6 also provides the guidance that tolerable misstatement may be the same amount or an amount smaller than performance materiality. The AICPA Audit Guide, *Audit Sampling* (AICPA Sampling Guide) (paragraph 4.52) explains that tolerable misstatement may be viewed as an extension of the concept of performance materiality used at the test level to accounts, balances or classes of transactions. In other words, *performance materiality* is materiality at the account balance or transaction class level. *Tolerable misstatement* is materiality at the test or procedure level, for a specific account balance or transaction class when that procedure or test is applied using audit sampling. The concept of tolerable misstatement and the approach to setting it are discussed in more detail in *PPC's Guide to Audits of Nonpublic Companies*.

Considerations in Determining Performance Materiality

AU-C 320.A14 explains that determination of performance materiality is not a simple mechanical calculation. It involves the exercise of professional judgment and is affected by the following:

- The auditor's understanding of the entity.
- Any need for revision identified in the performance of risk assessment procedures.
- The nature and extent of misstatements identified in previous audits.
- The auditor's expectations regarding misstatements in the current period.

It may also be helpful to consider the following:

- Performance materiality is a planning concept.
- Performance materiality is less than planning materiality.
- Performance materiality relates to the materiality level for a particular class of transactions, account balance, or disclosure.
- Performance materiality is set in a manner that reduces to an appropriately low level the probability that the aggregate of *uncorrected and undetected* misstatements exceeds the materiality level for the particular class of transactions, account balance, or disclosure.

Auditors need to establish at least one level of performance materiality. However, differing amounts can be established for various transactions classes, accounts balances, and disclosures. Exhibit 1-2 provides factors that auditors may consider when establishing performance materiality. Because performance materiality is set at an amount lower than planning materiality to allow for uncorrected and undetected misstatements, the exhibit illustrates the effect of the various factors on the potential allowance for undetected misstatement. For example, to achieve a higher allowance for undetected misstatement, performance materiality would need to be reduced in relation to planning materiality. The exhibit is adapted from Appendix J in the AICPA Audit Guide, *Assessing and Responding to Audit Risk in a Financial Statement Audit* (AICPA Risk Assessment Audit Guide).

The factors in Exhibit 1-2 are also considered when establishing tolerable misstatement for sampling purposes. To the extent that these factors are considered when determining performance materiality, tolerable misstatement might be equal to performance materiality. Tolerable misstatement is discussed further in *PPC's Guide to Audits of Nonpublic Companies*.

Exhibit 1-2

Factors to Consider When Establishing Performance Materiality

Factor	Conditions That May Result in a Lower Performance Materiality	Conditions That May Result in a Higher Performance Materiality	Comments
Total expected factual, judgmental, and projected misstatements	Greater amount of expected misstatements	Lower amount of expected misstatements	Allowance for undetected misstatement is normally higher when more misstatements are identified.
Management's willingness to make proposed adjustments	Management resists making adjustments	Management corrects factual and many judgmental misstatements	Allowance for undetected misstatements can be lessened when misstatements are adjusted.
Number of accounts involving management estimation	Significant number of accounts require estimation	Few accounts require estimation	Allowance for undetected misstatements would normally increase when there are significant amounts subject to estimation.
Locations, subsidiaries, or samples within an account where separate procedures are applied for each location and are aggregated in reaching audit conclusions	Significant number of locations, subsidiaries, or samples within an account	Few locations, subsidiaries, or samples within an account	Allowance for undetected misstatements is normally higher given the imprecision of many samples.

*   *   *

Using the PPC Approach to Determine Performance Materiality

Professional standards do not discuss precisely how performance materiality is to be determined. At the conclusion of the audit, the auditor needs to be able to reach the judgment that the risk is relatively low that the financial statements as a whole are materially misstated. This ultimate objective can provide a general conceptual framework for determining performance materiality.

Conceptually, the aggregate of misstatements for a particular class of transactions, account balance, or disclosure, which consists of detected but uncorrected misstatements and undetected misstatements, cannot exceed the amount for that class, balance, or disclosure that would materially misstate the financial statements as a whole. The aggregate amount for the financial statements as a whole at the planning stage of the audit is planning materiality. Thus, the residual of planning materiality less aggregate detected and uncorrected misstatement would be performance materiality, which in this framework is an allowance for undetected misstatement. The uncorrected misstatement is the aggregation of factual misstatement plus projected and judgmental misstatement from the application of audit procedures using audit sampling and analytical procedures, respectively, less the misstatement the client agrees to correct.

At the planning stage, the auditor cannot know the amounts of *factual misstatements* that will be detected and that the client will not correct, or the *projected or judgmental misstatements* that will result from the application of audit procedures using audit sampling or analytical procedures. However, the auditor may be able to make reasonable estimates of those amounts. In that case, the auditor could deduct the sum of those estimates from planning materiality to estimate performance materiality. However, because of the difficulty of making these estimates, many auditors prefer to use a rule of thumb approach that produces satisfactory results in most circumstances as discussed in the following paragraph.

The approach suggested by this course using the framework described above is to determine performance materiality as a percentage of the auditor's judgment about the amount material to the financial statements taken as a whole. The percentage used is based on the auditor's expectation of uncorrected and undetected misstatements. Using this approach, a common rule of thumb is to calculate performance materiality as a fraction between 50% and 75% of materiality at the financial statement level with the percentage being increased from 50% as the likelihood of uncorrected and undetected misstatements decreases. Appendix J of the AICPA Risk Assessment Audit Guide also supports using a guideline of 50% to 75% when setting performance materiality. Likewise, the AICPA Sampling Guide notes as practical guidance that tolerable misstatement ranges of 50 percent to 75 percent of materiality has often been shown to be adequate to allow for the factors influencing the performance materiality and tolerable misstatement amount. Tolerable misstatement is discussed further in *PPC's Guide to Audits of Nonpublic Companies*.

The 50% guideline is based on the maximum adjustment normally made in monetary unit (MUS) sampling applications to allow for the projected misstatements expected in sample results. Usually this 50% adjustment is conservative, that is, the extent of testing will be greater than necessary. Typically, for most nonpublic entities it is likely that the larger adjustment of 75% will be satisfactory. When the auditor expects a relatively large amount of factual misstatements to remain uncorrected or relatively large judgmental or projected misstatements (or other factors in Exhibit 1-2 exist that would increase the allowance for undetected misstatement), an adjustment closer to 50% is necessary. Although this rule of thumb was developed for sampling applications, it may also be useful and produce appropriate results for audit areas in which a nonsampling audit approach is used. This is true, in large part, because the performance materiality amount is a planning tool used to determine that adequate audit work is performed to achieve audit objectives and not an amount used to evaluate whether the misstatement of a particular class, balance, or disclosure is material.

However, professional standards require the auditor to consider whether, in the specific circumstances of the entity, misstatements of particular classes of transactions, account balances, or disclosures of lesser amounts than planning materiality could be expected to influence economic decisions of users. Any such amounts determined represent lower materiality levels to be considered in relation to the particular classes of transactions, account balances, or disclosures in the financial statements for audit planning purposes. In other words, in addition to determining materiality at the financial statement level, the auditor determines whether there are particular classes of transactions, account balances, or disclosures for which a lower planning materiality amount is appropriate based on user perceptions of the particular items. Many auditors believe, for example, that a lower materiality threshold is appropriate for related party transactions and balances. Therefore, the auditor may determine and document more than one level of planning materiality and more than one level of performance materiality. If performance materiality changes as the audit progresses, AU-C 320.14 requires the auditor to document the revisions.

FINANCIAL STATEMENT ASSERTIONS

AU-C 315.04 defines *assertions* as "representations by management, explicit or otherwise, that are embodied in the financial statements as used by the auditor to consider the different types of potential misstatements that may occur." AU-C 315.A128 explains that assertions used by the auditor fall into the following three categories:

- Assertions about classes of transactions and events for the period under audit.
- Assertions about account balances at period end.
- Assertions about presentation and disclosure.

AU-C 315.A128 and the paragraphs below further explain the individual assertions within those three categories.

Assertions for Classes of Transactions

Assertions about transaction classes relate to the entire period under audit and consist of the following:

a. *Occurrence.* Transactions and events that have been recorded have occurred and pertain to the entity.

b. *Completeness.* All transactions and events that should have been recorded have been recorded.

c. *Accuracy.* Amounts and other data relating to the recorded transactions and events have been recorded appropriately.

d. *Cutoff.* Transactions and events have been recorded in the correct accounting period.

e. *Classification.* Transactions and events have been recorded in the appropriate accounts.

In practice, auditors often use an assertion, phrased in the form of an audit objective, expressed as: "All transactions or events are recorded accurately as to account, amount, and period." That audit objective encompasses the assertion categories of accuracy, cutoff, and classification.

Assertions for Account Balances

Assertions about account balances relate to the period end and consist of the following:

a. *Existence.* Assets, liabilities, and equity interests exist.

b. *Rights and Obligations.* The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.

c. *Completeness.* All assets, liabilities, and equity interests that should have been recorded have been recorded.

d. *Valuation and Allocation.* Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

Generally, valuation or allocation has been viewed as relating to either (a) issues of recognition and measurement *subsequent* to initial recording, or (b) recording estimates or accruals. For example, the appropriateness of the gross amount of accounts receivable has been regarded as included in the existence assertion, while the valuation assertion is related to determining the net collectible amount of receivables. Valuation relates to account balances that require an estimate after initial recording to determine value, such as uncollectible receivables, obsolete inventory, or other asset impairments. Allocation relates to items for which an expense related to usage is allocated over useful life, such as property and certain intangibles or amortization of premiums or discounts related to liabilities.

Assertions for Presentation and Disclosure

Assertions about presentation and disclosure can relate to matters during the period or at the period end and consist of the following:

a. *Occurrence and Rights and Obligations.* Disclosed events have occurred and pertain to the entity.

b. *Completeness.* All disclosures that should have been included in the financial statements have been included.

c. *Classification and Understandability.* Financial information is appropriately presented and described and disclosures are clearly expressed.

d. *Accuracy and Valuation*. Financial information is disclosed fairly and at appropriate amounts.

This separate enumeration of assertion categories related to presentation and disclosure recognizes the importance of potential misstatements that can occur in the financial reporting process related to the assembly of information and its portrayal in the financial statements. In other words, transactions and events can be recorded properly and the resulting assets, liabilities, and equity interests can be recorded properly, but potential misstatements can still occur in the process of preparing the financial statements. Further, this category of assertions explicitly recognizes the importance of the understandability or clarity of disclosures.

The primary matters related to presentation and disclosure that are considered in audit programs for individual audit areas are (a) the proper classification of accounts for financial statement presentation (classification) and (b) ensuring that the workpapers include information that supports disclosures and that such information has been subjected to appropriate audit procedures (occurrence, accuracy, and valuation). Accuracy and classification is further considered by agreeing or reconciling the financial statements to the general ledger. The completeness and understandability of disclosures are ordinarily more fully considered in the audit work related to the process of preparing the financial statements, that is, in the general audit program. For example, the completeness of disclosures is considered by using a disclosure checklist and by evaluating whether based on the auditor's knowledge of the client's business and industry there are other matters of importance that should be disclosed, including whether additional information is necessary to make the disclosed information not misleading. The understandability or clarity of disclosures, as well as matters of occurrence and rights and obligations, are considered by a careful review of the financial statements and disclosures in light of the auditor's knowledge about the client gained throughout the audit.

Relevant Assertions

The auditor assesses risks of material misstatement at the relevant assertion level and designs audit procedures to mitigate that assessed risk. AU-C 315.04 defines a *relevant assertion* as one "that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated." A routine example is that the valuation assertion is usually not relevant to the cash account unless currency translation is involved. Another example is that the valuation assertion is usually not relevant to the gross amount of the accounts receivable balance, but is usually relevant to the related allowance for doubtful accounts. Additionally, the valuation and rights or obligations assertions are generally not directly relevant to the income statement. Those assertions generally relate to balance sheet accounts that may well affect the income statement, but not to income statement accounts directly. For example, the impairment of a fixed asset would directly affect the valuation of that asset and indirectly affect the income statement by a charge against earnings.

Auditors generally focus on those assertions that have some realistic chance of being misstated for a particular item. The identification and assessment of risks of material misstatement made to prepare the audit plan and determine the nature, timing, and extent of further procedures are made at the relevant assertion level. For example, AU-C 315.27 requires the auditor to relate identified risks to what can go wrong at the relevant assertion level. References to "decisions made at the relevant assertion level" mean decisions made about the relevant assertions within a class of transactions, account balance, or disclosure.

AU-C 315.A132 indicates that for each significant class of transactions, account balance, and disclosure, the auditor should determine the relevance of each financial statement assertion. Relevant assertions are identified by evaluating the following:

- The source of likely potential misstatement in each significant class of transactions, account balance, and disclosure.
- The nature of the assertion.
- The volume of transactions or data related to the assertion.
- The nature and complexity of the systems, including the use of IT, by which the entity processes and controls information supporting the assertions.

By understanding assertions that are relevant to an account balance, class of transactions, or disclosure and how identified risks relate to them, the auditor can effectively design and link further audit procedures that are responsive to the assessment of the risk of material misstatement.

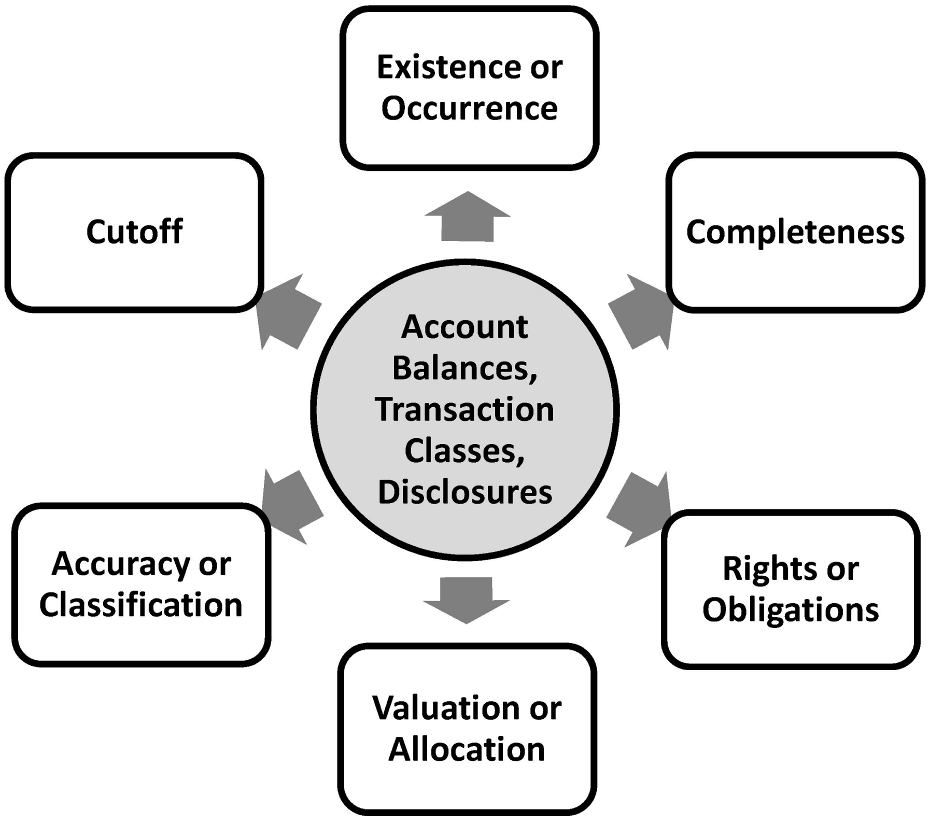
Implementation of Assertion Categories

AU-C 315.A129 notes that the auditor may use the relevant assertions as they are described above or may express them differently provided aspects described therein have been covered. For example, the auditor may choose to combine the assertions about transactions and events with the assertions about account balances. This means the auditor can continue to use generalized materials structured around broad categories of assertions that have been widely used in practice.

Using the PPC Approach. To facilitate the assessment of risks at the assertion level, this course recommends the categories of assertions indicated in Exhibit 1-3, which are integrated in the PPC audit approach.

Exhibit 1-3

Categories of Assertions Using the PPC Audit Approach



* * *

These categories cover all of the categories of assertions for transactions and events and account balances, as well as those aspects of presentation and disclosure that are considered in the audit programs for individual audit areas. The following audit objective can be used in the general audit program to encompass the remaining assertions about presentation and disclosure that are considered in the process of preparing the financial statements: "Financial statements are presented in accordance with GAAP. Required disclosures are complete, clearly expressed and understandable, and contain financial and other information that is fairly disclosed at appropriate amounts."

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. What is the term for materiality at the transaction class or account balance level?

    a. Tolerable misstatement.

    b. Performance materiality.

    c. Risk of material misstatement.

    d. Assertions.

2. Which of the following is one of the three categories of assertions that are typically used by auditors?

    a. Assertions about events and transaction classes during the audit period.

    b. Assertions about account balances at the beginning of the audit period.

    c. Assertions about performance materiality.

    d. Assertions about generally accepted accounting procedures (GAAP).

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. What is the term for materiality at the transaction class or account balance level? **(Page 7)**

   a. Tolerable misstatement. [This answer is incorrect. *Tolerable misstatement* is materiality at the test or procedure level for a specific account balance or transaction class when that procedure or test is applied using audit sampling.]

   b. Performance materiality. [This answer is correct. *Performance materiality* is the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. In other words, performance materiality is materiality at the account balance or transaction class level.]

   c. Risk of material misstatement. [This answer is incorrect. According to AU-C 200.14, *risk of material misstatement* is the risk that the financial statements are materially misstated prior to the audit.]

   d. Assertions. [This answer is incorrect. According to AU-C 315.04, *assertions* are representations by management, explicit or otherwise, that are embodied in the financial statements as used by the auditor to consider the different types of potential misstatements that may occur.]

2. Which of the following is one of the three categories of assertions that are typically used by auditors? **(Page 9)**

   a. Assertions about events and transaction classes during the audit period. [This answer is correct. AU-C 315.A128 explains that assertions used by the auditor fall into three categories. One such category is assertions about classes of transactions and events for the period under audit.]

   b. Assertions about account balances at the beginning of the audit period. [This answer is incorrect. According to AU-C 315.A128, one of the three types of assertions is those about account balances at period end, not the beginning of the period.]

   c. Assertions about performance materiality. [This answer is incorrect. AU-C 315.A128 lists three categories of assertions used by auditors, but assertions about performance materiality is not one of them.]

   d. Assertions about generally accepted accounting procedures (GAAP). [This answer is incorrect. Three categories of assertions are mentioned in AU-C 315.A128. While assertions about GAAP is not one of the categories listed, AU-C 315.A128 does include assertions about presentations and disclosures.]

SYNTHESIS: THE IDENTIFICATION OF RISKS OF MATERIAL MISSTATEMENT AT THE RELEVANT ASSERTION LEVEL

AU-C 315.26 indicates that for the purposes of designing and performing further audit procedures, the auditor should identify and assess risks of material misstatement at both the financial statement level and the relevant assertion level. For the purpose of assessing the risks of material misstatement at the relevant assertion level related to account balances, transaction classes, and disclosures, AU-C 315.27 indicates that the auditor should do the following:

a. Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks.

b. Assess the identified risks and evaluate whether they potentially affect many assertions because of their pervasive effect on the financial statements.

c. Relate the identified risks to what can go wrong at the relevant assertion level, considering relevant controls to be tested.

d. Consider whether the risks are of a magnitude that could result in a material misstatement of the financial statements.

e. Consider the likelihood that the risks, including the potential for multiple misstatements, could result in a material misstatement of the financial statements.

Items a through d are discussed below. Item b involves evaluating whether the identified risks have a pervasive effect on many of the assertions and affect the risk assessment at the financial statement level or have a more direct effect on specific classes of transactions, account balances, or disclosures, as discussed in this section of the course. Item e, likelihood, is a function of the assessed levels of inherent and control risk, which is discussed later in this lesson. The risk assessment approach described in this course is appropriate for assessing the risk of material misstatement due to either error or fraud.

The auditor uses information gathered to identify risks that may result in material misstatement of the financial statements. The auditor's identification of risks is a matter of professional judgment. It is more than reviewing a checklist of risk factors or red flags. It encompasses all of the auditor's knowledge of the client, including knowledge obtained about the entity and its environment, its management, the industry in which it operates, its internal control, and risk factors.

Risks are articulated in terms of what can go wrong in the financial statements at the assertion level. This is done, in part, because the presence of risks may only become evident when information from different sources is combined. That is, when analyzed in combination or as a whole, seemingly unrelated information might indicate a potential risk. In addition, it is difficult to link risks with responses unless the risks are stated in terms of their potential effects on the financial statements.

In performing risk assessment and other planning procedures, the auditor gathers information that may be relevant to identifying risks. Prior to performing risk identification, information gathered is merely information that *may* be relevant in identifying risks. This is because the presence of risks may only become evident when information from different sources is combined. For instance, seemingly unrelated information might indicate a potential risk only when analyzed in combination or as a whole. The auditor can apply professional judgment to combine, or synthesize, information gathered to identify the areas where the entity's financial statements might be susceptible to material misstatement due to error or fraud.

Gathering Information from Risk Assessment and Other Planning Procedures

During an audit, the auditor performs procedures to obtain an understanding of the entity and its environment, including its internal control, and the information that is gathered throughout that process is used to identify risks of material misstatement. Information is gathered from a variety of sources by performing the following risk assessment and other planning procedures:

- Planning and preliminary engagement activities, including:
  - Acceptance and continuance procedures.
  - Establishing an understanding with the client.
- Obtaining an understanding of the entity and its environment, including its internal control, by performing:
  - Inquiries of management and others (including required fraud inquiries).
  - Observation and inspection.
  - Identification of fraud risk factors.
- Discussion among engagement team members.
- Preliminary analytical review.
- Review of interim financial statements, if applicable.
- Other planning procedures.

The auditor may gather information from any or all of those sources to identify risks. It is a good idea to accumulate all the relevant information before finalizing the risk identification, because risks often become evident only when information from different sources is combined.

When gathering information that may be relevant to identifying risks, some auditors may be tempted to prematurely dispose of information that might suggest potential risk indicators. It is better to avoid the temptation to dispose of individual pieces of information without considering them in the context of all the information gathered. When auditors perform risk assessment procedures to gather information, that information has not yet been evaluated to determine how it relates to the financial statements and what could go wrong. At that point, the information gathered is essentially "raw material." Further processing of that raw material may be necessary before potential risks of material misstatement can effectively be identified. The auditor can apply professional judgment to combine, or synthesize, information gathered to identify the areas where the entity's financial statements might be susceptible to material misstatement due to error or fraud. Once the auditor understands what can go wrong in the financial statements, he or she can develop an appropriate response to such risks.

The importance of avoiding the temptation to dispose of individual pieces of information based on materiality or mitigating controls without first considering them in the context of all the information gathered is illustrated in the following example.

Example 1-1: Considering mitigating controls too early in the process.

Laser Technology is a manufacturer of equipment used in document imaging. The company has grown through acquisition, and currently has three separate divisions operating in different states. Laser installed a new accounts payable processing system during the current year to centralize its invoice processing at the company's parent location. The new system includes internal controls, edit routines, and exception reports for matching invoices to purchase orders, setting up authorized vendors, and maintaining approval limits. All accounts payable employees, supervisors, and managers have been thoroughly trained in the new system. The centralized accounts payable department now processes all of the invoices previously processed at the three locations.

During the engagement team discussion, the audit staff of the Laser engagement discussed the fact that the company's new accounts payable system significantly improved internal controls and segregation of duties over invoice processing. When gaining an understanding of the entity and its environment by conducting inquiries of employees, the staff person was told that the transition to the new system went fairly smoothly. The hardest part of the transition was that the invoice processors at the parent location were not familiar with the individuals at the other locations who had invoice approval authority, and they also were not familiar with many of the new vendors in the centralized system. After a few months, however, they gained this familiarity and loved the new system. The staff person focused on the control improvements and failed to consider the risks associated with the upheaval caused during the change in systems. Therefore, this information was not documented as part of the auditor's inquiries.

As a result, the engagement team failed to gather information that would have helped them identify that the processing of accounts payable during the system implementation period represented a financial statement risk. It was later discovered that several major vendor accounts were inadvertently excluded from the new system, which resulted in an underaccrual of accounts payable at year-end.

Information the auditor collects for further evaluation does not necessarily represent a risk of material misstatement of the financial statements, nor does the information necessarily require an audit response. It is merely information that suggests a potential risk indicator. The information may represent a risk of material misstatement and require an audit response, or it may not. Therefore, auditors need not be overly concerned that accumulating too much information will result in audit inefficiency.

Information gathered by performing risk assessment and other planning procedures may be compared to the symptoms of an illness, as illustrated in the following example.

Example 1-2: Identifying a risk is like diagnosing an illness.

Sylvia Brown goes to Dr. Anderson's office complaining of aches and a fever. Dr. Anderson's first thought is that Sylvia probably has the flu. However, before he diagnoses her illness, he first gathers all the relevant symptoms. He interviews Sylvia and finds out she lives in a wooded area and was recently bitten by a tick. He then performs a physical examination and detects a rash. He also orders some blood tests to gather more information. Doctor Anderson accumulates the symptoms on Sylvia's chart, and then evaluates them together to diagnose her illness. When all of the symptoms are considered together, the doctor is able to diagnose Sylvia with Lyme disease, which often can be mistaken for the flu. Just as the symptoms gathered by the doctor are not illnesses but merely indications of illness, so the information gathered by the auditor is not a risk but simply an indication of risk.

Assume Dr. Anderson had quickly concluded, based on limited information, that Sylvia had the flu. He would have treated her for the wrong illness. This would be similar to trying to identify risks without having all of the relevant information. The auditor who identifies risks without performing sufficient risk assessment and other planning procedures may end up developing inappropriate responses.

Synthesizing the Information

Once auditors have accumulated information relevant to the identification of potential risks, the information is evaluated together. Auditors apply professional judgment to determine whether the information gathered during the risk assessment process, either individually or in the aggregate, indicates areas where the entity's financial statements might be susceptible to material misstatement (whether due to error or fraud). This course refers to this process as *synthesis*. Synthesis is a mental process involving analysis of the information gathered to identify risks.

Why Is Synthesis Important? The synthesis process helps the auditor:

a. Recognize how the pieces of information gathered, alone or in combination, could indicate circumstances where risks might exist.

b. Evaluate whether the circumstances could potentially result in material misstatement of the financial statements.

c. Articulate those circumstances in terms of what could go wrong at the relevant assertion level.

Only after the auditor can clearly articulate the risks can he or she ordinarily assess the risks and develop appropriate responses.

Often, there may not be a one-to-one relationship between the pieces of information gathered and risks of material misstatement of the financial statements. In many cases, it is the combining of seemingly unrelated information that presents a risk. In other cases, one piece of information, in and of itself, may represent a condition that indicates a risk. Further, the totality of the information gathered, when synthesized, could actually lead to the identification of an overall risk at the financial statement level, such as a lack of personnel with appropriate accounting and financial reporting skills. The synthesis process may be compared to putting a jigsaw puzzle together. It is usually difficult to tell from looking at an individual puzzle piece what the picture will be. However, as pieces are put together one by one, an image begins to take shape. When the puzzle is finished, the pieces form a picture.

Synthesis Considerations. Synthesis of the information gathered during the performance of risk assessment and other planning procedures allows auditors to identify risks that might be associated with seemingly unrelated information. To synthesize the information and identify risks, auditors consider the information in the context of:

- The type of risk (that is, whether it relates to error or fraud).
- The pervasiveness of the risk, that is, whether the risk is—
  - Pervasive to the financial statements taken as a whole.
  - Related to a relevant assertion(s) for specific classes of transactions, account balances, or disclosures.
- What can go wrong at the assertion level.
- If the risk is a potential fraud risk, how the information relates to the three fraud conditions generally present when fraud occurs (that is, incentives/pressures, opportunities, and attitudes/rationalizations) and the extent to which those fraud conditions have been observed.
- Whether the risk is of a magnitude that could result in material misstatement of the financial statements.

After the information is synthesized and risks of material misstatement are identified, the likelihood of the risks resulting in material misstatement is then assessed. The assessment of likelihood is a function of the assessed levels of inherent and control risk, which are discussed later in this lesson.

Exhibit 1-4 includes a visual presentation of the types of information gathered during the risk assessment process and the synthesis of that information. The identification of risks may also be influenced by the specific characteristics of the entity, such as its size, complexity, and ownership attributes. The following paragraphs discuss the primary considerations in performing the synthesis to identify risks. Although each of the auditor's considerations is discussed separately, the considerations often occur simultaneously.

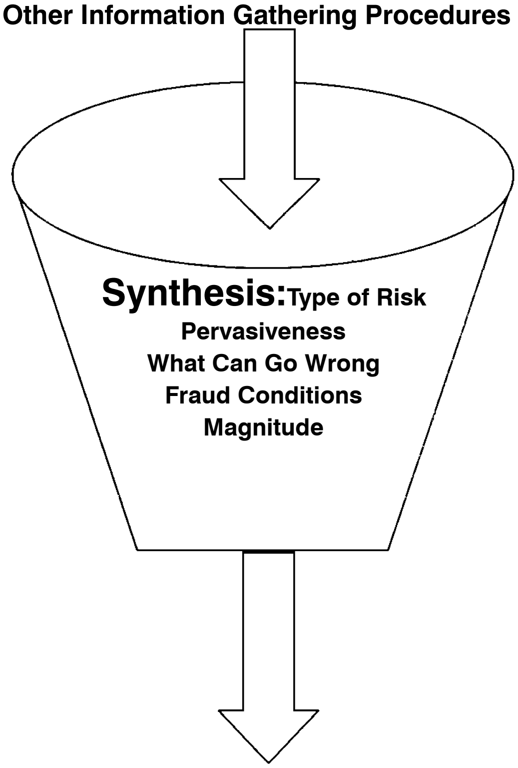
Considering the Type of Risk. In performing synthesis, the auditor considers the accumulated information to determine whether a potential risk relating to error or fraud exists. Because the synthesis process is highly judgmental, the risks identified by applying the process may be different depending on whether they relate to error or fraud. AU-C 240 emphasizes the importance of auditors exercising professional skepticism when considering the possibility that a risk of material misstatement due to fraud could be present. If the risk relates to fraud, auditors consider whether the information indicates the entity is susceptible to misappropriation of assets or fraudulent financial reporting.

Considering the Pervasiveness of the Risk. The auditor considers the information gathered and determines whether it indicates a risk that may be pervasive to the financial statements as a whole or a risk that relates to a specific class of transactions, account balance, or disclosure. For example, a risk associated with a weak control environment is pervasive to the financial statements because misstatements are unlikely to be confined to a particular account balance, class of transactions, or disclosure. On the other hand, the risk of overstatement of inventory due to an underaccrual of the inventory obsolescence reserve is specifically related to the valuation assertions (and disclosures) for the inventory accounts.

Exhibit 1-4

The Synthesis Process

Engagement Team Discussion
Inquiry of Management and Others
Observation and Inspection
Identification of Fraud Risk Factors
Preliminary Engagement Activities
Preliminary Analytical Procedures
Other Information Gathering Procedures



Identified Risks
Likelihood of Misstatement

*   *   *

The auditor's determination of whether risks affect related assertions of specific classes of transactions, account balances, or disclosures or whether they are pervasive to the financial statements as a whole is useful in determining appropriate audit responses. Generally, auditors respond to pervasive risks by altering their overall audit strategy, while auditors respond to specific risks at the assertion level by altering the nature, timing, and extent of their further audit procedures. Considering pervasiveness is illustrated in the following examples.

Example 1-3: Risk is related to a relevant assertion for a specific account balance.

When performing risk assessment procedures, the auditor of Arlington Associates identifies a risk that certain repairs may be capitalized as equipment. This represents a risk of misstatement for the existence assertion for the equipment account and a risk of misstatement for the completeness assertion for the repairs and maintenance expense account.

Example 1-4: Risk is pervasive to the financial statements as a whole.

While performing risk assessment procedures, the auditor of Lawson Corporation determines that there is a weak control environment surrounding the monthly and year-end financial reporting closing processes.

Because this weakness can affect numerous account balances, the risk is an overall risk that may be pervasive to the financial statements as a whole.

Considering What Can Go Wrong at the Assertion Level. The purpose of performing risk assessment is to identify and respond to risks of material misstatement of the financial statements. Although much of the information gathered to identify risks may relate to the entity's business risks, the focus is on risks that may have a material direct or indirect effect on the financial statements. Not all business risks give rise to risks of financial statement misstatement.

As part of the synthesis process, the auditor considers how the potential risk could affect specific assertions related to account balances, transaction classes, or disclosures. What could the potential risk cause to go wrong in the financial statements? And more specifically, what assertions relating to particular account balances, transaction classes, or disclosures could be affected? How could they be affected?

As discussed earlier in this lesson, PPC's approach uses the following assertion categories:

- Existence or occurrence.
- Completeness.
- Rights or obligations.
- Valuation or allocation.
- Accuracy or classification.
- Cutoff.

By taking the "what could go wrong" scenario down to the assertion level, the auditor can more easily consider the potential severity and implications of the risk. Considering what can go wrong at the assertion level is illustrated in the following examples.

Example 1-5: Translating a risk into what can go wrong at the assertion level.

While performing risk assessment procedures, the auditor of Dorsey Company determines that the entity engages in bill and hold transactions. When the auditor considers what can go wrong in the financial statements, he determines that a year-end inventory balance could be presented that is greater than the inventory the entity actually owns if the entity fails to exclude the inventory held for others from its physical count. Thus, this risk represents an existence (and rights or obligations) risk that could result in an overstatement of inventory.

Example 1-6: Articulating another risk as a risk at the assertion level.

While performing risk assessment procedures, the auditor of Parks Industrial Supplies determines that a number of significant customer accounts receivable are over 90 days and no allowance for doubtful accounts has been accrued at year-end. When the auditor considers what can go wrong in the financial statements, she determines that the period-end accounts receivable balance could include amounts that will not ultimately be collected. Thus, the risk represents a valuation risk that could result in an overstatement of accounts receivable.

Considering Fraud Conditions. AU-C 240 indicates that, when identifying fraud risks, it may be helpful to consider the information gathered in the context of the three conditions generally present when fraud occurs: incentives/pressures, opportunities, and attitudes/rationalizations. That is, auditors consider whether the information may indicate incentives to commit fraud, opportunities to carry it out, or attitudes/rationalizations to justify it.

The nature of the observed fraud conditions may assist the auditor in determining the type of risk. For example, information related to personal financial obligations or dissatisfaction of employees, assets susceptible to theft, and inadequate safeguarding controls generally indicates susceptibility to misappropriation of assets. Information related to external pressures to present favorable financial condition or operating results, accounts or transactions susceptible to manipulation, and inadequate monitoring and financial reporting controls generally indicates susceptibility to fraudulent financial reporting.

Fraud conditions may relate to observed attitudes or rationalizations. For example, auditors may have observed changes in behavior or lifestyle that indicate increased risk that misappropriation might be occurring. Similarly, auditors may have observed an interest by management in employing inappropriate means to minimize earnings for tax-motivated reasons, an excessive interest in the selection and application of accounting policies, or use of the concept of materiality to justify inappropriate accounting. These conditions provide an indication of increased risk that management may be manipulating the financial statements.

The accumulated information may indicate only one fraud condition, or it may indicate all three. However, the auditor does not assume it is necessary to observe all three conditions before concluding there are fraud risks. Although the risk of material misstatement due to fraud may be greatest when all three conditions exist, auditors may not be able to observe the presence of all of these conditions. Some of these conditions, such as attitude, are difficult to observe but may, nonetheless, be present. In addition, even if all of the conditions are not observed as present, fraud can still occur. In some cases, the extent of one condition may be so significant that fraud risks exist, even though the other conditions are not significant. For example, a significant incentive to commit fraud, such as to prevent a loan default, may alone be sufficient to constitute a risk of material misstatement due to fraud. Similarly, an easy opportunity to commit fraud, such as poor asset safeguarding, may alone be sufficient to constitute a fraud risk. The consideration of observed fraud conditions requires considerable judgment, as illustrated in the following examples.

Example 1-7: Identifying a fraud risk with only one observed condition.

Rhome Industries is a manufacturer of computer hardware, including desktop and laptop computers and peripherals. The computers and peripherals are small in size and high in demand, and have potential value to employees for personal use or sale. In addition, the warehouse is kept open during the day and due to cost-cutting measures there is no security guard or surveillance camera in the warehouse to monitor the movement of goods. As a result, employees have the opportunity to steal the assets because there are inadequate safeguarding controls. Although there is no indication that employees have a motivation to steal or an attitude that enables them to justify stealing, the presence of opportunity alone may be sufficient to identify a risk of misappropriation of assets related to inventory.

Example 1-8: Identifying a fraud risk with multiple observed conditions.

Barrett Industries is a manufacturer of heavy equipment used in the farming industry. Barrett Industries maintains tight controls over the company's inventory, which diminishes the risk of misappropriation of assets. However Barrett's industry is declining with increased business failures and the company is facing the threat of imminent bankruptcy if it is unable to secure additional financing. The cost of inventory items is based on a complex cost allocation process involving a number of subjective estimates. Management is dominated by the company's founder and owner/manager, David Marcell, who is heavily invested in the business. Based on these circumstances, Marcell is under pressure to present favorable operating results to avoid bankruptcy. Further, the presence of accounting estimates involving complex, subjective judgments provides him the opportunity to commit and conceal fraudulent financial reporting. Thus, sufficient fraud conditions exist to identify risk of fraudulent financial reporting. (In this case, the incentive to avoid bankruptcy alone might be sufficient to cause the auditor to identify a fraud risk, but if there was no incentive, the auditor might conclude that the mere existence of subjective accounting estimates does not result in identifying a fraud risk but a risk of error.)

Presumption of Revenue Recognition as a Fraud Risk. Material misstatement of the financial statements due to fraudulent financial reporting often results from improper revenue recognition. Revenue may be overstated, such as by recording fictitious sales or recognizing revenue before it is earned, or understated, such as by shifting revenue to a later period. Therefore, AU-C 240.26 requires auditors to make the rebuttable presumption that improper revenue recognition is a risk of material misstatement of the financial statements due to fraud and to evaluate which types of revenue, revenue transactions, or assertions give risk to the risk. Risks of material misstatement due to fraud are always significant risks. The Observations and Suggestions at paragraph 5.31 of the AICPA Risk Assessment Audit Guide state that significant risks are those with inherent risk that is "higher than the usual high," thus requiring special attention in the audit. Therefore, best practices indicate that the presence of fraud risk qualifies revenue as significant audit area.

However, the presumption that improper revenue recognition is a fraud risk, and the accompanying designation of revenue as a significant audit area, may be overcome. Affirmative reasoning and an evaluation of observed fraud conditions, rather than negative reasoning, such as "nothing came to our attention," ordinarily are needed to overcome the presumption. Affirmative reasons may include, for example, (a) revenue recognition does not involve complex accounting for the type of business, (b) the owner/manager or other senior management is not involved in negotiating or recording sales, or (c) essentially all sales are for cash. If the auditor lacks an affirmative reason to overcome the presumption that revenue recognition is a fraud risk, or if the auditor has observed the presence of fraud conditions related to improper revenue recognition, he or she evaluates that information with a heightened awareness of the need to identify improper revenue recognition as a fraud risk. Because revenue is generally material to the financial statements, if there are one or more indications of potential improper revenue recognition gathered during the risk assessment process, it is unlikely that auditors can overcome the presumption. If improper revenue recognition is not identified as a risk of material misstatement of the financial statements due to fraud, auditors are required by AU-C 240.46 to document the reasons supporting their conclusion.

Information that suggests a potential risk of improper revenue recognition may, at first glance, not seem directly related to revenue. For example, the existence of debt covenants that are difficult to maintain may not initially prompt an auditor to consider the risk of improper revenue recognition. The auditor may need to dig deeper to identify the specific risk associated with a particular risk factor. However, any information that suggests an incentive or pressure to overstate or understate an entity's results causes the auditor to consider an appropriate response to the risk of improper revenue recognition. In addition, absent an effective oversight process, the opportunity for improper revenue recognition almost always exists because of the possibility that management can override controls.

Best practices indicate that, as with any audit risk assessment, risk of improper revenue recognition due to fraud may vary by assertion. Therefore, auditors when considering risk factors, and their implications for the audit, auditors consider the effects at the assertion level. Additional work may be required in certain areas to reduce audit risk to an acceptable level. The following are examples of revenue risks by assertion that may require special focus when planning the audit:

- *Existence or Occurrence.* Significant pressure to achieve financial results may give management an incentive to overstate revenue in the current period.
- *Completeness.* Poor overall financial performance in the current period may lead management to understate current revenue to boost revenues in the next period, giving an illusion of recovery, or to reduce current period taxes owed.
- *Rights or Obligations.* Failure to identify or comply with contractual performance obligations may result in improper deferral or acceleration of revenue recognition.
- *Valuation or Allocation.* Complex transactions or those requiring a high degree of judgment may be subject to management bias, resulting in misstated revenue.
- *Accuracy or Classification.* Revenue may not be presented in the financial statements in accordance with GAAP (or other special purpose framework) or entity policy, especially in the period of adoption of a new accounting standard or in a period with significant new contracts. Complex or highly subjective transactions may lead to inaccurate revenue recognition.
- *Cutoff.* Several of the risk factors noted above could also result in revenue being recognized in the incorrect period.

In addition, risk may vary for different areas of the entity's business. For example, inherent risk for existence or occurrence may be assessed as high due to presumed fraud risk for only one product line or other subset of the entity's business due to present fraud risk factors.

AU-C 330.22 notes that when there are significant risks at the relevant assertion level, substantive procedures should include tests of details when the response consists of only substantive procedures (i.e. no reliance is being placed on internal control). Substantive analytical procedures may also be applied; however analytical procedures alone would not be sufficient to address the assessed risk(s) of material misstatement due to fraud.

Considering the Magnitude of the Risk. Magnitude refers to whether the risk could result in a material misstatement of the financial statements. Essentially, it is a consideration of materiality. For example, for a risk related to a potential underaccrual of an entity's allowance for doubtful accounts, materiality is primarily quantitative. That is, could the allowance for doubtful accounts be underestimated by such an amount that the financial statements could be materially misstated? However, magnitude is not limited only to quantitative considerations. Some consideration also needs to be given to the qualitative aspects of materiality. In certain cases, implications of potential misstatements that might otherwise be immaterial could be considered material to financial statement users. For example, a risk that could also have an effect on other financial statement components needs to be more carefully considered. Considering magnitude is illustrated in the following examples.

Example 1-9: Considering quantitative magnitude.

While performing risk assessment procedures, the auditor of Nelson Corporation identifies a risk of understatement of accounts payable due to a lack of accrual of invoices payable at year-end. Because the auditor is aware of a number of significant purchases made by the entity just prior to the end of the year, he determines that the magnitude of the understatement of accounts payable could be such that the misstatement could be material to the financial statements.

Example 1-10: Considering magnitude, including qualitative factors.

While performing risk assessment procedures, the auditor of Crowe, Inc. identifies a risk that the entity's investment in a joint venture may be misstated. The auditor is aware that the users of the financial statements under audit include the entity's joint venture partners. The auditor determines that the magnitude of the potential misstatement may not be material to the financial statements taken as a whole, but it could be significant to the joint venture partners. As a result, the auditor determines that the misstatement is of a sufficient magnitude to be identified as a risk.

When evaluating the magnitude of potential fraudulent financial reporting risks, qualitative considerations are particularly important because the fraud involves deception of financial statement users. A common belief is that fraudulent misstatement of financial statements is by definition material. The reasoning goes that because the goal of the fraud is to deceive users of the financial statements, the fraud would have to be material to influence the judgment of the user. However, that does not necessarily mean the fraudulent misstatement would have to be quantitatively material to the financial statements. If the auditor gathers information that results in identifying a potential fraud risk related to manipulation of the financial statements, it seems unlikely that the auditor would conclude that the matter is not of a magnitude that could be significant to financial statement users.

Synthesis Questions. Exhibit 1-5 provides a list of questions auditors can ask to help determine whether the information gathered, individually or in combination, indicates a potential risk of material misstatement of the financial statements.

Exhibit 1-5

Synthesis Questions

What Type of Risk Exists?
• Does the risk relate to error or fraud? • If the risk is a fraud risk, does it relate to misappropriation of assets or fraudulent financial reporting?
Is the Risk Pervasive?
• Is the risk confined to an assertion(s) relating to a particular account balance, transaction class, or disclosure? • Is the risk of such a nature that multiple financial statement components could be affected?
What Can Go Wrong at the Assertion Level?
• What could the risk cause to go wrong in the financial statements?

• What account balance, transaction class, or disclosure in the financial statements would be affected by the risk? • What assertion does the risk relate to? • What is the direction of the risk (that is, overstatement or understatement)?
For Risks of Error:
• Is there a past history of errors relating to the assertion and account balance, transaction class, or disclosure? • Are there indications that the account balance, transaction class, or disclosure is susceptible to error? • Are there existing conditions or control weaknesses that make the entity vulnerable to error for this assertion and account balance, transaction class, or disclosure? • Are there any indications that errors may have occurred in the current period relating to the assertion and account balance, transaction class, or disclosure?
For Risks of Fraudulent Financial Reporting:
• What incentives or pressures exist for management to misstate the financial statements (e.g., pressure to overstate revenue or net income, reduce tax liability, or manipulate amounts related to loan covenants)? • Is there ineffective monitoring of management or does management fail to adequately monitor internal controls over the financial reporting process? • Does management communicate inappropriate values or ethics? • Does management display domineering behavior towards the auditor, especially involving attempts to influence the scope of the auditor's work or the auditor's judgment about the appropriateness of the selection and application of accounting principles? • Are there any indications that management might be manipulating the financial statements?
For Risks of Misappropriation of Assets:
• Which assets are most susceptible to misappropriation? • What conditions exist that might make the entity vulnerable to misappropriation? • Are there any indications that misappropriation might be occurring?
Could the Risk Result in a Material Misstatement of the Financial Statements?
• Could the risk result in a misstatement of such a magnitude that the financial statements taken as a whole could be materially misstated? • Are there additional qualitative considerations that ought to be considered in determining whether the magnitude of the misstatement could be material to the financial statements?

* * *

Identifying Risks of Material Misstatement

Articulating Risks. The output of the synthesis process is the articulation of identified risks and the assertions affected. Risks generally are stated in terms of what can go wrong in the financial statements at the assertion level. If auditors are as specific as possible when describing risks, it will assist in assessing risks and determining further audit procedures to be performed. A well-articulated risk will typically describe—

- The cause of the risk.
- The account balance, class of transactions, or disclosure and how it may be affected (that is, overstatement or understatement).
- If a fraud risk, the type of risk (misappropriation of assets or fraudulent financial reporting).
- The relevant assertion (or that it is an overall financial statement risk).

The assessment of identified risks and selection of appropriate responses can be a more effective process if the identified risks are well articulated, as illustrated in the following example.

Example 1-11: Identifying a risk—putting it all together.

While gaining an understanding of the entity and its environment, the auditor of Rosemont Industries identifies the potential risk that Rosemont's customer base is declining due to industry consolidation. The auditor relates that risk to what could go wrong at the assertion level as being a risk of overstatement of accounts receivable associated with valuation. The auditor then considers that, given the size of the receivable balance and the number and size of customers that potentially would be unable to meet their contractual obligations, the risk is of a magnitude that could result in material misstatement of Rosemont's financial statements. As a result, the auditor identifies a valuation risk due to uncollectible accounts that could result in an overstatement of accounts receivable.

Exhibit 1-6 presents examples of identified risks of material misstatement due to fraud or error and illustrates how those risks may be articulated in a way that is more meaningful for use in assessing risks and determining further audit procedures to be performed.

Exhibit 1-6

Articulating Risks

Poorly Articulated Risks	Well Articulated Risks
Inventory is highly liquid and the entity has poor safeguarding controls.	Overstatement of inventory due to theft (Existence)
A significant related-party sale recorded early in the year was still outstanding at year-end.	Overstatement of sales due to sham transactions with related parties (Occurrence)
The entity recorded no year-end liabilities for employee wages and benefits.	Understatement of accrued liabilities due to failure to make year-end payroll accruals (Completeness)
The entity consolidated a special-purpose entity without evaluating whether it meets the consolidation criteria of FASB ASC 810.	Overstatement of assets and liabilities due to improper consolidation of XYZ, Inc. (Rights)
The entity recorded a general liability contingency reserve.	Overstatement of liabilities due to recording obligations that are not probable (Obligations)
Inventory cost accounting method is highly complex and subjective.	Misstatement of inventory due to improper cost accounting (Valuation)
The entity's property balance did not change from the prior year.	Overstatement of assets due to failure to record depreciation expense (Allocation)
Year-end inventory pricing calculations were performed by one individual without review.	Overstatement or understatement of inventory due to misapplication of prices (Accuracy)
The entity has a significant new other asset account.	Overstatement of assets due to misclassification (Classification)
The entity recorded significant sales orders in the last month of the year.	Overstatement of sales due to improper cutoff (Cutoff)

*   *   *

Examples of Synthesis. Because synthesis requires professional judgment, auditors may identify different risks based on similar information depending on the client's specific circumstances. Exhibit 1-7 provides examples of how information gathered from various sources may be synthesized to identify risks of material misstatement. As illustrated in the exhibit, there may or may not be a one-to-one relationship between the information gathered and the risks identified.

Exhibit 1-7

Examples of Risks Identified through Synthesis

<table>
<tr><th>Source of Information</th><th>Information Gathered</th><th>Identified Risk</th></tr>
<tr><td>Understanding the entity and identifying risks:
• Nature of the entity (business operations)
• Objectives and strategies
• Internal control (risk assessment)</td><td>A new product was introduced into the market during the current year.</td><td rowspan="3">Understatement of the legal liability contingency reserve under FASB ASC 450, Contingencies (Completeness)</td></tr>
<tr><td>Understanding the entity and identifying risks—Internal control (monitoring activities)</td><td>Customer complaints are not adequately captured and monitored.</td></tr>
<tr><td>Understanding the entity and identifying risks:
• Nature of the entity (financial reporting)
• Inquiry of management
• Inquiry of outside legal counsel</td><td>A lawsuit was filed against the entity relating to a flaw in the design of the new product.</td></tr>
<tr><td>Understanding the entity and identifying risks—Internal control (control activities)</td><td>Controls over the summarization and pricing of the year-end physical inventory are weak.</td><td>Overstatement or understatement of inventory due to summarization and pricing errors (Accuracy)</td></tr>
<tr><td>Understanding the entity and identifying risks:
• Nature of the entity (business operations)
• Identification of fraud risk factors</td><td>The entity has a significant amount of marketable equipment.</td><td rowspan="2">Overstatement of equipment due to misappropriation (Existence)</td></tr>
<tr><td>Understanding the entity and identifying risks—Internal control (control activities)</td><td>The entity has poor physical safeguards over assets.</td></tr>
<tr><td>Understanding of the entity and identifying risks:
• Industry conditions
• Nature of the entity (business operations)</td><td>There is a new major competitor with brand recognition that entered the market during the year.</td><td rowspan="3">Overstatement of inventory due to obsolescence (Valuation)</td></tr>
<tr><td>Understanding of the entity and identifying risks:
• Inquiries of management
• Inquiries of others (inventory floor manager)</td><td>The new competitor has been successful at taking market share and sales have slowed significantly during the last half of the year.</td></tr>
<tr><td>Preliminary analytical procedures</td><td>The year-end inventory balance has increased sharply over the prior year balance. No reserve for inventory obsolescence has been recorded at year-end.</td></tr>
</table>

Source of Information	Information Gathered	Identified Risk
Understanding the entity and identifying risks: • Nature of entity (financial reporting) • Objectives and strategies • Inquiries of management • Internal control (risk assessment, monitoring and control activities)	The chief financial officer left the entity in the first quarter and the entity does not currently have a competent chief financial officer to oversee the financial reporting function.	Overall financial statement risk (which requires an overall response)
Understanding of the entity and identifying risks—Internal control (control activities)	There is a lack of segregation of duties within the payroll function.	Overstatement of payroll expense due to misappropriation of assets (Occurrence)
Understanding the entity and identifying risks: • Nature of the entity (investments, financing, financial reporting) • Objectives and strategies • Inquiry of management and others within the entity • Internal control (control activities)	The entity entered into an interest rate swap for the first time during the year.	Overstatement or understatement of liabilities and equity due to improper derivatives accounting (Valuation)
Engagement continuance procedures; Understanding of the entity and identifying risks: • Nature of the entity (financing and financial reporting) • Objectives and strategies Engagement team discussion; Understanding the entity and identifying risks: • Industry conditions • Inquiry of management • Identification of fraud risk factors Preliminary analytical procedures	The entity's loans with its primary bank have EBITDA and fixed charge coverage covenants that require earnings to increase over the life of the loans. The owner has personally guaranteed the debt. Over the past couple of years, the loan covenants are becoming more difficult to meet and the entity's relationship with the bank has been deteriorating. Amounts due from customers increased significantly during the last quarter.	Overstatement of revenue due to fraudulent financial reporting (Occurrence)

* * *

Documenting Identified Risks

AU-C 315.33 specifies the documentation requirements relating to understanding the entity and its environment and assessing the risks of material misstatement, of which identification is a part. According to AU-C 315.33, the auditor is required to document key elements of the understanding; sources of information from which the understanding was obtained; the risk assessment procedures performed; and the identification and assessment of risks of material misstatement, both at the financial statement level and the relevant assertion level. (As noted earlier in this lesson, AU-C 315.33 also requires documentation of risks that require special audit consideration and those for which substantive procedures alone do not provide sufficient appropriate evidence, as well as the related controls.)

Using the PPC approach, the auditor accumulates information from various sources by performing risk assessment and other planning procedures for use in identifying potential risks of material misstatement (due to error or fraud). Exhibit 1-8 lists numerous sources from which relevant information may be gathered for risk identification. The auditor may choose to perform and document such procedures, practice aids, such as those provided in *PPC's Guide to Audit Risk Assessment*, or by other means, such as with narrative descriptions, flowchart, or decision tables.

Exhibit 1-8

Information Gathered Through Risk Assessment and Other Planning Procedures

Risk Assessment and Other Planning Procedures
Obtaining an understanding of the entity and its environment, including internal control, through: • Inquiries of management and others • Observation and inspection • Identification of fraud risk factors
Discussion among engagement team members
Planning and preliminary engagement activities: • Establishing an understanding with the client • Acceptance and continuance procedures
Preliminary analytical procedures
Reviews of interim financial statements, if applicable

*   *   *

As noted above, AU-C 315.33 requires the auditor to document the identified and assessed risks of material misstatement at both the financial statement level and at the relevant assertion level. At the relevant assertion level, these risks include those that require special audit consideration (significant risks) and those for which substantive procedures alone do not provide sufficient appropriate evidence. AU-C 240.43 further requires the auditor to document the identified and assessed risks of material misstatement due to fraud, and AU-C 240.46 requires the auditor to document, if applicable, the reasons for overcoming the presumption that there is a risk of fraud related to improper revenue recognition. Risks that require special audit consideration and those for which substantive procedures alone do not provide sufficient appropriate evidence are discussed later in this lesson.

There is no requirement to document the synthesis process. The extent of documentation of the process auditors use to synthesize the information gathered to identify risks is a matter of professional judgment. The format and extent of the documentation may be influenced by the nature, size, and complexity of the entity.

Further Assessing Identified Risks

Once the auditor performs the synthesis process and identifies risks of material misstatement, those risks need to be further assessed. Based on that assessment, which considers the likelihood of material misstatement, the auditor will determine the nature, timing, and extent of further auditing procedures to be performed to reduce audit risk to an appropriately low level. Further discussion of assessing risks of material misstatement appears later in this lesson.

THE ASSESSMENT OF RISKS OF MATERIAL MISSTATEMENT AT THE RELEVANT ASSERTION LEVEL

AU-C 200.19 and paragraph 2.02 of the AICPA Risk Assessment Audit Guide note that auditors should perform their audits to reduce audit risk to an acceptably low level. The auditor's consideration of audit risk at the individual account balance, class of transactions, or disclosure level directly assists in determining the nature, timing, and extent of further audit procedures for the relevant assertions related to balances, classes of transactions, or disclosures. How the auditor gathers information from the risk assessment procedures and other procedures to identify the risks of material misstatement of the financial statements whether due to error or fraud, how the auditor relates the identified risks to what can go wrong at the relevant assertion level, and how the auditor considers whether the risks are of a magnitude that could result in a material misstatement of the financial statements were discussed earlier in this lesson. To assess the risk of material misstatement at the assertion level, the auditor then has to consider the likelihood that the identified risks could result in a material misstatement of the financial statements. Likelihood is a function of the assessed levels of inherent and control risk, which are discussed in this section.

The auditor's consideration and identification of risks of material misstatement due to fraud under the requirements of AU-C 240 is not separate from consideration of audit risk; rather, it is integrated into the overall audit risk assessment process described in this course and in *PPC's Guide to Audit Risk Assessment*.

The auditor needs to understand the following basic concepts to perform the assessment of risks of material misstatement at the assertion level:

- Financial statement assertions (which were discussed earlier in this lesson);
- the audit risk model; and
- the risk of material misstatement.

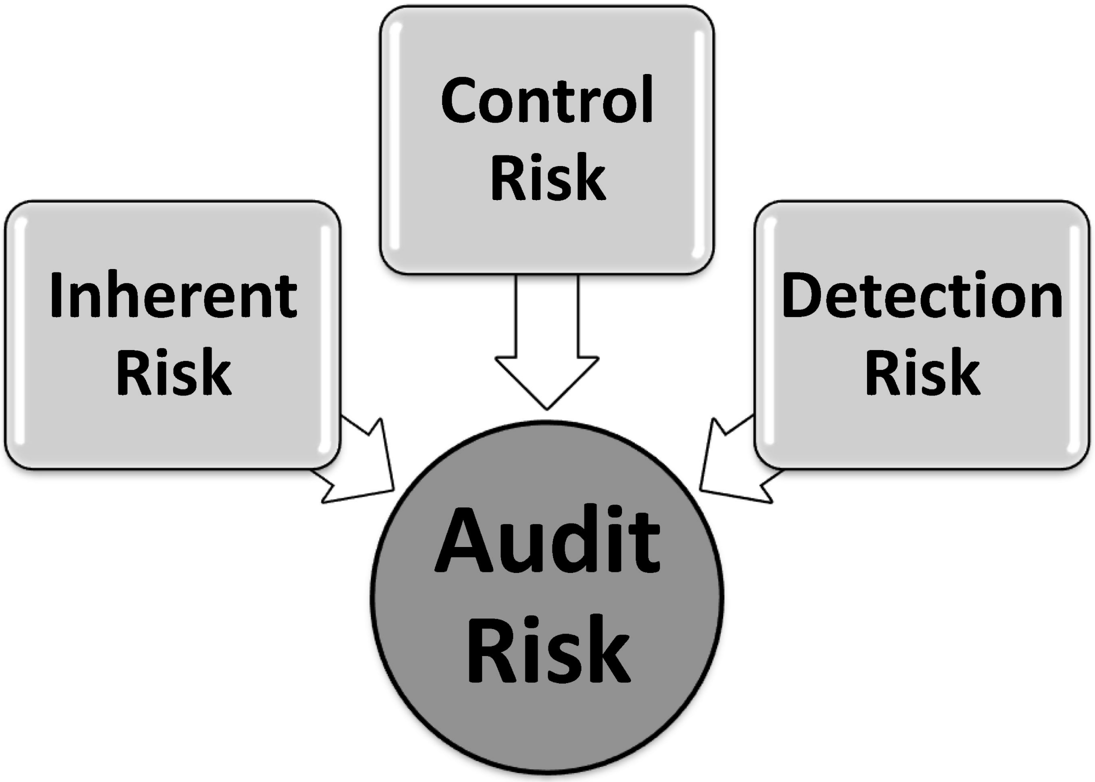
The Audit Risk Model

AU-C 200.14 defines *audit risk* as "the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated." It further explains that audit risk is a function of the risks of material misstatement and detection risk. AU-C 200.14 defines these terms as follows:

- *Risk of Material Misstatement*—The risk that the financial statements are materially misstated prior to the audit. This consists of two components, described as follows at the assertion level:
  - *Inherent Risk*—The susceptibility of an assertion about a class of transaction, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.
  - *Control Risk*—The risk that a misstatement that could occur in an assertion about a class of transaction, account balance, or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.
- *Detection Risk*—The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements. The components of audit risk are illustrated in Exhibit 1-9.

Exhibit 1-9

Components of Audit Risk



* * *

The audit risk concept can be expressed in formula form based on following:

- RMM—Risk of Material Misstatement
- IR—Inherent Risk
- CR—Control Risk
- DR—Detection Risk

DR is a function of the effectiveness of the nature, timing, and extent of substantive procedures applied by the auditor and can be viewed as being a function of the following two components:

- TD—Tests of Details Risk
- AP—Substantive Analytical Procedures Risk

Risk of Material Misstatement

As explained above, the risk of material misstatement (RMM) is a function of inherent risk (IR) and control risk (CR). The auditor assesses those two risks and then designs audit procedures to reduce detection risk to an appropriately low level. Fraud risks also encompass both inherent and control risk attributes. Therefore, the auditor's separate assessments of inherent and control risk include consideration of the risk of material misstatement due to fraud. The combined effect of inherent risk (IR) and control risk (CR) is the risk of material misstatement (RMM). In other words, aggregate risk of material misstatement in the risk model is expressed as follows:

$$RMM = IR \times CR$$

Inherent risk and control risk are the entity's risks and exist independently of the audit. The risk of material misstatement (RMM), the product of IR and CR, is the auditor's *combined* assessment of the two risks. The auditor may make an overall, or combined, assessment of the risk of material misstatement at the assertion level or make separate assessments of inherent risk and control risk and then combine them. In either approach, the AICPA Risk Assessment Audit Guide (paragraph 5.22) cautions the auditor to assess both components. For example, an auditor may assess inherent risk as low for a particular account because it is determined by a single monthly adjustment that is easy to calculate, the bookkeeper is believed capable of making the adjustment, and no misstatements have been identified in prior audits. In such a case, the auditor may be implicitly assuming that certain basic controls are in place and operating effectively and may actually be making a combined assessment of inherent and control risk rather than an assessment of just inherent risk. Thus, at the assertion level the audit risk model is as follows:

$$AR = RMM \times DR, \text{ where } DR = TD \times AP$$

The greater the risks of material misstatement, the less detection risk can be accepted. As a result, auditors would need to obtain more persuasive audit evidence.

In planning a particular test of details, the detection risk is established by the following relationship:

$$TD = \frac{AR}{RMM \times AP}$$

The model is not intended to be a mathematical formula including all factors that influence the assessment of audit risk, but some auditors find such a model in its formula form to be useful.

Assessing the Risk of Material Misstatement at the Relevant Assertion Level

The assessment of audit risk at the relevant assertion level, whether made in quantitative terms (e.g., percentages) or nonquantitative terms (e.g., high, moderate, or low), is a judgment rather than a precise measurement of risk.

The auditor needs to have an appropriate basis for the judgment about risk at the relevant assertion level. This basis is obtained through the risk assessment procedures performed to obtain an understanding of the entity and its environment, and, if applicable, through the performance of suitable tests of controls.

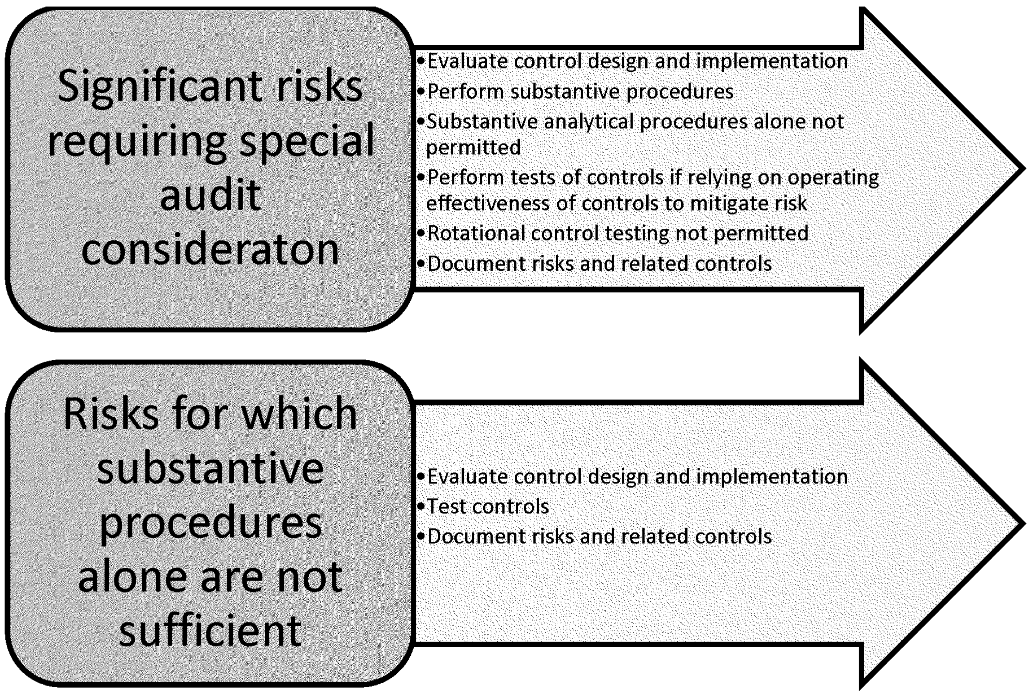
AU-C 315.33 requires that the assessment of the risks of material misstatement at the relevant assertion level be documented. This means that for each material account balance, transaction class, or disclosure the auditor should document the assessed risk of material misstatement for each relevant assertion. Separate documentation of inherent risk and control risk is not required. For account balances, transaction classes, or disclosures that are not significant, the auditor may be able to conclude that the risks are the same for all assertions and document that conclusion.

The auditor can assess the risks of material misstatement at the relevant assertion level in nonquantitative terms or, if the auditor wishes, in quantitative terms using the formula for the risk model. The only time that use of the formula for the audit risk model and specific percentages are necessary is when statistical sampling is used, but the formula can be useful in other circumstances as well. The auditor can determine an acceptable audit risk and subjectively quantify the judgment of the risk of material misstatement (consisting of inherent risk and control risk), and the risk that substantive analytical procedures and other relevant substantive procedures would fail to detect material misstatements that could occur in an assertion. In other words, the auditor's quantification of the components of the risk model is always made subjectively. Even when the auditor quantifies the components as a percentage, the judgment is subjective and not a mathematical calculation. Whichever method is used, the auditor's assessment of audit risk at the relevant assertion level is a judgment rather than a precise measurement of risk.

Special Risk Considerations. The auditor's risk assessment should include an evaluation of whether certain special types of risks, as shown in Exhibit 1-10, are present.

Exhibit 1-10

Special Types of Risks and Related Requirements



* * *

Those risks are discussed in the following paragraphs.

Significant Risks Requiring Special Audit Consideration

AU-C 315.28 indicates that, as part of his or her risk assessment, the auditor should determine whether any of the risks identified are significant risks. That determination excludes the effects of identified controls related to the risk. AU-C 315 refers to such risks as risks that require special audit consideration. The AICPA Risk Assessment Audit Guide notes in paragraph 5.31 that in most audits one or more significant risks normally arise. It observes with respect to the determination of significant risk that in a situation in which the auditor assesses inherent risk as high, moderate, or low, a significant risk may be one that is higher than high and, thus, requires special audit consideration.

The auditor's determination of significant risks is based solely on the consideration of *inherent risk*, that is, before consideration of the effect of identified controls related to the risk. The AICPA Risk Assessment Audit Guide in paragraph 5.31 observes that the auditor determines whether the risk is such that it requires special audit consideration by focusing on the following:

- The nature of the risk.
- The likely magnitude of the potential misstatement, including the possibility of multiple misstatements.
- The likelihood of the misstatement occurring.

Each of these aspects of the auditor's consideration need attention in determining whether special audit consideration is necessary, but the nature of the risk is particularly important.

According to AU-C 315.29, the nature of the risk should be evaluated by considering the following:

- Is the risk a risk of fraud or theft?
- Is the risk related to recent significant economic, accounting, or other developments?
- Are the transactions complex?
- Does the risk involve significant transactions with related parties?
- Is there a relatively large degree of subjectivity in the measurement of the financial information related to the risk?
- Does the risk involve significant transactions outside the normal course of business or that otherwise appear unusual?

An affirmative answer to any of these questions is likely to indicate the need for a specific audit response and, thus, a determination that the risk is a significant risk because it requires special audit consideration. Risks of material misstatement due to fraud are always significant risks. Risks of material misstatement due to error also may be deemed significant risks depending on their nature. As indicated above, in determining significant risks, it is helpful to consider the degree of inherent risk. The Observations and Suggestions following paragraph 5.31 of the AICPA Risk Assessment Audit Guide suggest that it may be helpful to compare all high inherent risks to each other to assist with the identification of significant risks.

Examples of matters that often involve significant risks include the following:

- Significant nonroutine transactions, that is, transactions that are unusual due to their size or nature.
- Accounting estimates for which there is significant measurement uncertainty, such as environmental remediation liabilities or certain fair value estimates.
- Transactions that involve complex calculations or the application of complex accounting principles, such as self-constructed property with capitalized interest or revenue recognition for software that is tailored for the customer.
- Financial statement items for which management judgments (such as judgments about when it is appropriate to recognize revenue, management's intended future actions, or the likelihood of a future event) may affect recognition, classification, or disclosure.
- Significant related party transactions.
- Transactions that require a large degree of manual intervention in data collection and processing.
- Unusual or infrequent transactions that by their nature make effective controls difficult to implement, such as major litigation.
- Transactions that involve a relatively large degree of management intervention in specifying the accounting treatment.

The AICPA Risk Assessment Audit Guide (in the Observations and Suggestions following paragraph 5.31) cautions that the unnecessary designation of too many risks as significant risks can impair the efficiency of the audit. Also, as noted in Lesson 2, if the auditor plans to rely on the operating effectiveness of controls relating to a significant risk, the auditor cannot use evidence obtained in prior periods about the effectiveness of such controls.

Exhibit 1-11 provides a set of questions that were derived from the AICPA Risk Assessment Audit Guide (in the Observations and Suggestions following paragraph 5.31) that might be considered by the auditor to determine whether a risk truly requires special audit consideration.

Exhibit 1-11

Questions to Consider When Determining Risks That Require Special Audit Consideration

- Which risks are most likely to require the immediate, focused attention of the auditor with the final responsibility for the audit? If a concurring review is required, which risks would receive the initial attention of the concurring reviewer?
- Which risks are atypical and could lead to material misstatement?
- Given previous experience with the client, which risks were unexpected?
- For which risks would the auditor be reluctant to apply only substantive analytical procedures?
- Hypothetically, if there was a constraint on available time to perform the audit, which risks are certain to be addressed through substantive tests of details?

* * *

The identification of risks of material misstatement as significant risks (based on consideration of inherent risk) has important implications for further audit procedures, including tests of controls. Once the auditor has identified the risk as a significant risk, the auditor would ordinarily do the following:

- To the extent the auditor has not already done so, evaluate the design of the entity's related controls, including relevant control activities, and determine whether they have been implemented (required by AU-C 315.30).
- Determine whether the audit approach will involve reliance on controls.
- If the auditor plans to rely on the operating effectiveness of controls intended to mitigate the significant risk, perform tests of controls in the current period. Reliance on evidence from tests of controls performed in prior periods is not permitted.
- Perform substantive procedures that are specifically responsive to the risk.
- If the auditor does not plan to rely on controls and is performing only substantive procedures, the substantive procedures should be tests of details only or a combination of tests of details and substantive analytical procedures. Use of only substantive analytical procedures is not permitted. (AU-C 330.22 notes that when there are significant risks at the relevant assertion level, substantive procedures should include tests of details when the response consists of only substantive procedures.)
- Document the significant risks identified and related controls evaluated (required by AU-C 315.33).

In determining the appropriate audit response to significant risks, the auditor considers his or her understanding of the relevant controls, including control activities. The most effective audit approach may depend on whether management has identified the risk and responded by designing and implementing effective controls.

Because risks designated as significant risks require special audit consideration, the auditor needs to evaluate whether the risk is pervasive for the assertion or more limited. Often a significant risk relates to a particular aspect of an assertion and can be addressed separately. With respect to the existence of property, plant, and equipment, for example, the capitalization of software costs or the capitalization of costs of self-constructed assets may be significant risks, but other aspects of the existence assertion may pose only normal risks. Another example is the existence assertion or valuation assertion for investments. Derivative investments may pose significant risks, but other investments may not. The auditor needs to avoid unnecessarily identifying all aspects of an assertion for an account balance, transaction class, or disclosure as a significant risk when that designation applies only to a particular aspect of the assertion that can be addressed separately.

Risks for Which Substantive Procedures Alone Are Not Sufficient

As part of the auditor's risk assessment, the auditor identifies those risks for which it is not possible or practicable to reduce detection risk at the relevant assertion level to an acceptably low level with audit evidence obtained only from substantive procedures, that is, substantive procedures alone will not be sufficient. Such risks often occur in audit areas in which there is highly automated processing with little or no manual intervention, that is, a significant amount of the entity's information is initiated, authorized, recorded, processed, or reported electronically.

Examples of situations of this type are described in AU-C 315.A149 as follows:

a. An entity that conducts its business using IT to initiate orders for the purchase and delivery of goods based on predetermined rules of what to order and in what quantities and to pay the related accounts payable based on systems-generated decisions initiated upon the confirmed receipt of goods and terms of payment. No other documentation of orders placed or goods received is produced or maintained, other than through the IT system.

b. An entity that provides services to customers via electronic media (for example, an Internet service provider or a telecommunications company) and uses IT to create a log of the services provided to its customers to initiate and process its billings for the services, and to automatically record such amounts in electronic accounting records that are part of the system used to produce the entity's financial statements.

The AICPA Risk Assessment Audit Guide (paragraph 3.106) indicates that when determining whether substantive procedures alone will be sufficient to gather appropriate audit evidence, the auditor might consider:

- *Characteristics of Available Audit Evidence.* For example, in highly automated systems with little or no manual intervention, there may be no paper audit trail because audit evidence exists only in electronic form. In that case, the ability to determine whether the electronic information provides sufficient audit evidence usually depends on the effectiveness of controls over its accuracy and completeness.

- *Greater Risks of Material Misstatement.* When information is initiated, recorded, processed, or reported in only electronic form with little or no manual intervention, and controls are not operating effectively, there may be increased risk, for example, that inappropriate transactions are initiated or electronically stored information is altered.

After considering these factors, the auditor might determine that it is not possible to reduce audit risk to an acceptable level without testing controls.

In some cases, there may be an overlap of significant risks and risks for which substantive procedures alone are not sufficient. For example, health care providers generally have complex billing calculations that create significant risks. In addition, their billing systems involve a significant amount of information that is initiated, authorized, recorded, processed, and reported electronically; therefore, the auditor has to perform tests of controls to obtain evidence about the operating effectiveness of controls over the accuracy and completeness of the information generated by the billing systems.

When it is not possible or practicable to reduce detection risks at the relevant assertion level to an acceptably low level with audit evidence obtained only from substantive procedures, the auditor would ordinarily do the following:

- Evaluate the design and determine the implementation of relevant controls, including control activities, over those risks (required by AU-C 315.31).

- Perform tests of controls to obtain evidence about their operating effectiveness.

- Document the risks identified and related controls evaluated (required by AU-C 315.33).

If the risks are also significant risks, the guidance provided above on that topic is also applicable.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

3. Which of the following auditors has correctly addressed an issue related to gathering information and synthesizing the risk of material misstatement at the relevant assertion level?

   a. Allison limits the information she gathers about these risks to her preliminary analytical review procedures.

   b. Benjamin disposes of certain pieces of information when he determines that, independently, they are low risk.

   c. Catherine articulates risks using a description of what might go wrong in the financial statements at the assertion level.

   d. Dominick prepares an audit response for the information he collects for his evaluation of risk.

4. Which of the following statements best describes part of the synthesis process?

   a. The risk assessment process is based more on considerations prescribed by authoritative literature than judgment.

   b. The most appropriate response to a pervasive risk is to keep the nature, timing, and extent of further audit procedures the same as originally planned.

   c. Incentives, opportunities, and rationalizations are key conditions that should be weighed when determining the risk of fraud.

   d. When determining the magnitude of a potential risk, if the amount would be less than performance materiality it is not a risk.

5. While performing an audit engagement, Michael discovers that his client has a large amount of equipment that could be sold on the open market. He also determines that his client's physical safeguards over these assets are poor. What type of financial statement risk has Michael identified?

   a. The entity's legal liability contingency reserve may be understated.

   b. The entity's inventory may be over or understated due to pricing errors or summarization.

   c. Due to misappropriation of the assets, the entity has overstated its payroll expenses.

   d. The entity's equipment may be overstated due to misappropriation.

6. What is the correct term for the risk that the auditor's procedures to reduce audit risk will not detect an existing material misstatement?

   a. Audit risk.

   b. Inherent risk.

   c. Control risk.

   d. Detection risk.

7. Which of the following risks would most likely be considered significant?

    a. Risk 1 is related to possible fraud committed by an employee.

    b. Risk 2 occurs in a stable economic environment.

    c. Risk 3 relates to simple transactions.

    d. Risk 4 involves an independent third party.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

3. Which of the following auditors has correctly addressed an issue related to gathering information and synthesizing the risk of material misstatement at the relevant assertion level? **(Page 15)**

   a. Allison limits the information she gathers about these risks to her preliminary analytical review procedures. [This answer is incorrect. Information is gathered throughout the process from a variety of sources, including (1) planning and preliminary engagement activities; (2) obtaining an understanding of the entity and its environment, including its internal control; (3) discussion among engagement team members, (4) preliminary analytical review; (5) review of interim financial statements, if applicable; and (6) other planning procedures. Therefore, by limiting her information gathering, Allison may overlook potential risks.]

   b. Benjamin disposes of certain pieces of information when he determines that, independently, they are low risk. [This answer is incorrect. When gathering information that may be relevant to identifying risks, some auditors may be tempted to prematurely dispose of information that might suggest potential risk indicators. It is better to avoid the temptation to dispose of individual pieces of information without considering them in the context of all the information gathered. Benjamin needs to evaluation the information he gathers as a whole and use his professional judgment to determine if it indicates potential risks.]

   c. Catherine articulates risks using a description of what might go wrong in the financial statements at the assertion level. [This answer is correct. Risks are articulated in terms of what can go wrong in the financial statements at the assertion level. This is done, in part, because the presence of risks may only become evident when information from different sources is combined. That is, when analyzed in combination or as a whole, seemingly unrelated information might indicate a potential risk. In addition, it is difficult to link risks with responses unless the risks are stated in terms of their potential effects on the financial statements. Therefore, by articulating her risks in this way, Catherine is effectively assessing risks for her audit engagement.]

   d. Dominick prepares an audit response for the information he collects for his evaluation of risk. [This answer is incorrect. Dominick is overauditing. Information the auditor collects for further evaluation does not necessarily represent a risk of material misstatement of the financial statements, nor does the information necessarily require an audit response. It is merely information that suggests a potential risk indicator. The information may represent a risk of material misstatement and require an audit response, or it may not. Therefore, auditors need not be overly concerned that accumulating too much information will result in audit inefficiency.]

4. Which of the following statements best describes part of the synthesis process? **(Page 20)**

   a. The risk assessment process is based more on considerations prescribed by authoritative literature than judgment. [This answer is incorrect. Because the synthesis process is highly judgmental, the risks identified by applying the process may be different depending on whether they relate to error or fraud.]

   b. The most appropriate response to a pervasive risk is to keep the nature, timing, and extent of further audit procedures the same as originally planned. [This answer is incorrect. The auditor's determination of whether risks affect related assertions of specific classes of transactions, account balances, or disclosures or whether they are pervasive to the financial statements as a whole is useful in determining appropriate audit responses. Generally, auditors respond to pervasive risks by altering their overall audit strategy, while auditors respond to specific risks at the assertion level by altering the nature, timing, and extent of their further audit procedures.]

c. Incentives, opportunities, and rationalizations are key conditions that should be weighed when determining the risk of fraud. [This answer is correct. AU-C 240 indicates that, when identifying fraud risks, it may be helpful to consider the information gathered in the context of the three conditions generally present when fraud occurs: incentives/pressures, opportunities, and attitudes/rationalizations. That is, auditors consider whether the information may indicate incentives to commit fraud, opportunities to carry it out, or attitudes/rationalizations to justify it.]

d. When determining the magnitude of a potential risk, if the amount would be less than performance materiality it is not a risk. [This answer is incorrect. Magnitude refers to whether the risk could result in material misstatement of the financial statements. Essentially it is a consideration of materiality. However, magnitude is not limited only to quantitative considerations. Some consideration also needs to be given to the qualitative aspects of materiality. In certain instances, implications of potential misstatements that might otherwise be immaterial could be considered material to financial statement users.]

5. While performing an audit engagement, Michael discovers that his client has a large amount of equipment that could be sold on the open market. He also determines that his client's physical safeguards over these assets are poor. What type of financial statement risk has Michael identified? **(Page 26)**

a. The entity's legal liability contingency reserve may be understated. [This answer is incorrect. Information that would support Michael articulating this risk includes (1) a new product introduced into the market in the current year, (2) customer complaints were not adequately captured and monitored, and (3) a lawsuit was filed against the entity relating to a flaw in the design of the new product. The information gathered above is indicative of a different type of risk.]

b. The entity's inventory may be over or understated due to pricing errors or summarization. [This answer is incorrect. Michael might have articulated this risk if he discovered that controls over the summarization and pricing of the year-end physical inventory are weak. A different articulated risk is indicated by the information above.]

c. Due to misappropriation of the assets, the entity has overstated its payroll expenses. [This answer is incorrect. Michael might articulate this as a risk if he discovered that his client has a lack of segregation of duties within its payroll function. However, the information Michael discovered in this scenario applies to a different articulated risk.]

d. The entity's equipment may be overstated due to misappropriation. [This answer is correct. The articulated risk of "overstatement of equipment due to misappropriation" relates to the existence assertion and is supported by the two pieces of information Michael discovered in this scenario. He could find out about the entity's amount of equipment when obtaining an understanding of the entity and identifying the nature of the entity and its fraud risk factors. He could find out about the poor safeguards when obtaining an understanding of the entity and identifying risks related to internal control.]

6. What is the correct term for the risk that the auditor's procedures to reduce audit risk will not detect an existing material misstatement? **(Page 29)**

a. Audit risk. [This answer is incorrect. According to AU-C 200.14, audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is an overarching term made up of several smaller components, one of which is the type of risk described above.]

b. Inherent risk. [This answer is incorrect. According to AU-C 200.14, this is the susceptibility of an assertion about a class of transaction, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls. Therefore, the definition above is associated with a different term.]

c. Control risk. [This answer is incorrect. Based on the guidance provided in AU-C 200.14, *control risk* is the risk that a misstatement that could occur in an assertion about a class of transaction, account balance, or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.]

d. Detection risk. [This answer is correct. Per the definitions provided in AU-C 200.14, *detection risk* is the term described above. The full definition states that this is the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.]

7. Which of the following risks would most likely be considered significant? **(Page 33)**

a. Risk 1 is related to possible fraud committed by an employee. [This answer is correct. According to AU-C 315.29, if a risk is a risk of fraud or theft, that likely indicates the need for a specific audit response and, thus, a determination that the risk is a significant risk because it requires special audit consideration. Risks of material misstatement due to fraud are always significant risks.]

b. Risk 2 occurs in a stable economic environment. [This answer is incorrect. Based on the guidance in AU-C 315.29, a risk is more likely to be considered significant if it is related to significant economic, accounting, or other developments. Since Risk 2 is related to a stable economic environment that has not changed, all other things being equal, this factor does not increase Risk 2's likelihood of significance.]

c. Risk 3 relates to simple transactions. [This answer is incorrect. All other things being equal, based on the guidance in AU-C 315.29, a risk is more likely to be considered significant if it involves complex transactions. Since Risk 3 does not, its likelihood of needing special audit consideration is not increased.]

d. Risk 4 involves an independent third party. [This answer is incorrect. Risks involving significant transactions with related parties are more likely to be considered significant, per AU-C 315.29. Therefore, since Risk 4 is related to an independent third party, any related significance would have to come from a different factor.]

PREPARING THE DETAILED AUDIT PLAN

AU-C 330.06 indicates that the further audit procedures the auditor designs and performs should be responsive to the assessed risks of material misstatement at the relevant assertion level. In designing further audit procedures, AU-C 330.07 indicates that the auditor should consider the reasons for the assessed risk of material misstatement, including the likelihood of material misstatement and whether reliance on controls is planned, and obtain more persuasive evidence in higher risk areas. AU-C 330.A8 notes that the design and performance of audit procedures that are based on, and are responsive to, the assessed risks of material misstatement at the relevant assertion level provides a clear linkage between the assessment and further audit procedures. The Observations and Suggestions to paragraph 5.37 of the AICPA Risk Assessment Audit Guide note that *linkage* describes the relationship between the assessed risks and further audit procedures. *Clear linkage* implies that the further audit procedures are responsive to the assessments and that the assertions of the assessed risks are closely correlated to those addressed by the substantive procedures.

A description of the nature, timing, and extent of planned further audit procedures at the relevant assertion level is a significant component of the audit plan. AU-C 300.09 indicates that the auditor should develop an audit plan that includes a description of the following:

a. The nature and extent of planned risk assessment procedures.

b. The nature, timing, and extent of planned further procedures at the relevant assertion level.

c. Other planned procedures required by GAAS.

AU-C 300.10 notes that the auditor should update and change the audit plan as needed during the audit.

As part of developing the overall audit strategy the auditor will ordinarily have identified material locations (or components) and account balances and audit areas where there may be higher risks of material misstatement. Once the audit strategy has been established, the auditor is able to start the development of a more detailed audit plan to address the various matters identified in the audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources. The audit plan is commonly referred to as the audit program.

There are many ways to increase audit efficiency while maintaining audit effectiveness. Many auditors focus on trying to minimize the time spent performing their audit procedures. Although this is important, it addresses only part of the process. It is also critical to choose audit procedures that effectively and efficiently accomplish the auditor's objectives. This course suggests a practical approach to developing and documenting the audit plan that is responsive to the requirements of professional standards and aimed at achieving both audit efficiency and effectiveness.

Documentation Requirements

AU-C 330.30 requires the auditor to document the following related to preparing the detailed audit plan:

- Overall responses to the assessed risks of material misstatement at the financial statement level.

- Nature, timing, and extent of further audit procedures performed.

- Linkage of the procedures performed with the assessed risks at the relevant assertion level.

- Results of the audit procedures performed, including conclusions that are not otherwise clear.

As noted above, AU-C 300.09 states that the audit plan should include the following:

- A description of the nature and extent of planned risk assessment procedures sufficient to assess the risks of material misstatement.

- A description of the nature, timing, and extent of planned further audit procedures at the relevant assertion level for each material class of transactions, account balance, and disclosure.

- A description of other audit procedures planned to be carried out for the engagement in order to comply with generally accepted auditing standards (for example, seeking direct communication with the entity's lawyers).

Planning for audit procedures takes place during the course of the audit and risk assessment procedures may cause a change in planned specific further audit procedures. AU-C 300.10 requires the auditor to update and modify the audit plan as necessary throughout the audit and AU-C 300.14 notes that the auditor should document changes to the original audit plan and the reasons.

How to Perform and Document the Specific Risk Assessment and the Planned Response

The auditor should document the specific risk assessment at the assertion level and the planned response (i.e., audit approach). The auditor can perform the following steps:

- Identify any general risk assessment factors that affect the risk of material misstatement for particular account balances, transaction classes, or disclosures.

- Determine those audit areas that are significant.

- Describe the specific risks of material misstatement that affect the account balance, transaction class, or disclosure; identify the financial statement assertion affected; and consider the significance of the risks.

- Determine the documentation approach to be used when assessing the risk of material misstatement at the relevant assertion level.

- Make a qualitative assessment of inherent risk as high, moderate, or low.

- Make a qualitative evaluation of control risk as high, moderate, or low.

- Make a qualitative assessment of the remaining or combined risk of material misstatement as high, moderate, or low based on the prior evaluations of inherent risk and control risk.

- Determine the response to the risk assessment by selecting an audit approach that includes sufficient further audit procedures to adequately respond to the risk assessment.

- Describe any relevant comments on audit approach, including any modifications of audit procedures made in response to fraud risks or other significant risks. (AU-C 240 requires auditors to document their responses to identified fraud risks. AU-C 315 requires auditors to document their responses to significant risks.

Identifying General Risk Assessment Factors. The identification of risks at the financial statement level might identify factors that increase the specific risk of material misstatement for particular account balances, transaction classes, or disclosures. For example, if the auditor's overall risk assessment indicates a higher risk of senior management manipulating the financial statements, the auditor might identify significant accounting estimates as having a higher specific risk of material misstatement because of the general susceptibility of estimates to senior management bias. In that case, the auditor would identify specific risks related to the valuation assertion for account balances or transaction classes involving a relatively large degree of estimation. The auditor would also identify those risks as fraud risks because they relate to fraudulent financial reporting. Similarly, if the auditor noted that management had poor monitoring controls over the development of estimates and the use of judgments, the auditor might similarly identify specific risks related to the valuation assertion for significant accounts that involved a higher degree of judgment. However, in this case, the auditor might consider this risk of potential misstatements to relate to error versus fraud.

The example in the previous paragraph illustrates how matters that represent risks at the financial statement level may also result in risks at the assertion level. Because of their nature, accounting estimates and related parties can both have that effect. As a result, AU-C 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, and AU-C 550, *Related Parties*, require certain specific procedures to be performed as part of identifying and assessing the risks of material misstatement in accordance with AU-C 315.

Special Considerations—Accounting Estimates. AU-C 540.10–.11 indicates that as part of risk assessment, the auditor should evaluate the degree of estimation uncertainty of accounting estimates and determine whether any having a high degree of estimation uncertainty represent significant risks. The degree of estimation uncertainty associated with a particular accounting estimate may be influenced by a number of factors, as described in AU-C 540.A45–.A46. Further, AU-C 540.12 indicates that the auditor is required to determine, based on the risk assessment, whether (a) management has appropriately applied GAAP to the accounting estimate, (b) the method for making the estimate is appropriate and applied consistently, and (c) any change in the estimate or method from the prior period is appropriate. See *PPC's Guide to Audits of Nonpublic Companies* for further discussion.

Special Considerations—Related Parties. AU-C 550.19 states that the auditor should identify and assess the risks of material misstatement associated with related party relationships and transactions in order to determine whether they represent significant risks. In addition, AU-C 550.20 indicates that if related party fraud risk factors are identified, the auditor should consider them in identifying and assessing fraud risks. See *PPC's Guide to Audits of Nonpublic Companies* for more in-depth discussion.

Determining Significant Audit Areas. The next step is to identify those audit areas that are significant. (An audit area encompasses the related account balances, transaction classes, and disclosures.) The following factors need to be considered in determining which audit areas are significant:

- Relative materiality of the account balance to the overall financial statements.
- Relative significance of the transaction class to the entity's operations or overall financial statements (for example, because of either the materiality or volume of transactions flowing through the account during the period).
- The susceptibility of the account balance or transaction class to fraud, including both theft or similar loss of related assets and intentional misstatement by management (that is, audit areas that contain fraud risks).
- Audit areas that for other reasons (such as complex calculations, difficult or contentious accounting issues, new accounting standards, need for judgment, unusual nature of transactions, past history of significant adjustments, or other engagement risk factors) have a high assessed level of inherent risk or contain significant risks.
- Disclosures that require additional effort at the account balance level in individual audit areas to ensure their accuracy and completeness.

Materiality of the Account Balance to the Financial Statements. One element of significance is the dollar amount of an account balance in relation to the auditor's judgment of the amount material to the financial statements taken as a whole. Judgment is needed even in making these quantitative comparisons because account balances are usually not completely misstated. Account balances, other than liabilities and valuation allowances, with an ending balance below performance materiality would generally be regarded as quantitatively immaterial and not significant. Account balances that are some multiple of performance materiality are generally quantitatively significant. Account balances that are approximately equal to performance materiality require careful consideration as to the nature of the account balance and prior experience with the client in evaluating significance.

Generally, the importance of the recorded amount in evaluating significance depends on whether the primary concern is with overstatement or understatement. The maximum amount that an account balance can be overstated is the dollar amount of the balance. If the auditor's primary concern for a particular account balance is a risk of overstatement, then the recorded amount of the account balance is the upper limit of misstatement. For account balances for which the auditor's primary concern is understatement, such as liabilities and valuation allowances, the recorded amount is not a limit on misstatement. Therefore, evaluating materiality for those account balances involves other considerations.

In the abstract, there is no limit on the amount of understatement, but there is usually some constraining factor. For example, the recorded dollar amount of accrued warranty expense payable is not a measure of the significance of the account balance. The auditor would need to consider the length of the warranty period; the dollar volume of products sold with an unexpired warranty; the client's prior experience concerning the relation between total sales and warranty claims, and warranty claims and warranty expenses; and, finally, any changes in the client's business or economic environment that would affect historical trends. The dollar volume of products with an unexpired warranty puts a limit on the potential understatement, but the auditor would want to make a more refined analysis in evaluating the significance of the account balance.

Other Matters That Affect Significance. Quantitative significance of the account balance is only one of several matters to be considered when identifying significant audit areas. In evaluating significance, the auditor also needs to consider any other matters that qualitatively affect the account balance, transaction class, or disclosure. For example, freight expense would be more significant if the auditor plans to use data on quantities shipped to make a predictive test of total revenue. Professional fees would have greater significance if the auditor is concerned that there is an inadequate understanding of the client's litigation exposure and the identity of all attorneys engaged during the period. There might be very material disclosures related to small account balances. For example, a joint venture investment might be small at the balance-sheet date, but a subsequent events note might indicate a subsequent major investment in that joint venture project that holds the key to the client's future success. The auditor needs to draw on the knowledge and understanding of the client to identify the account balances, transaction classes, or disclosures that are significant in the circumstances.

Documenting Significant Audit Areas. As discussed above, significant audit areas are those areas that contain material account balances, significant transaction classes, fraud risks or other significant risks, or disclosures that require additional effort at the account balance level in individual audit areas to ensure their accuracy and completeness. The auditor can document which audit areas are considered significant. This information is important when determining the effect of the risk assessment on the audit.

Describing Specific Risks of Material Misstatement. For each audit area, the auditor documents the specific risks of material misstatement affecting the account balance, transaction class, or disclosures. The description includes the cause and direction of potential misstatement as well as the financial statement assertions affected. The auditor considers the cause of misstatement—error, fraudulent financial reporting, or theft—and the effect on direction of misstatement. Auditors are required to document any fraud risks or other significant risks they identify.

Determining the Documentation Approach to Be Used When Assessing the Risk of Material Misstatement. The auditor needs to assess the risk of material misstatement at the relevant assertion level. For audit areas that are not significant, or for significant areas where the auditor has not identified any specific risks, it may be appropriate and more efficient to document the risk assessment for the audit area as a whole. If that is done, the risk assessment is assumed to be the same for all assertions and would be the highest level of risk for any assertion in the audit area. Auditors need to exercise caution when documenting the assessment at the audit area level. Failure to consider the level of risk related to each assertion could result in an inappropriate or inefficient response. For example, the auditor might inadvertently focus on one or more assertions and assess risk for the audit area as "moderate" while other relevant assertions for the area have a "high" risk of misstatement. As a result, the audit approach chosen based on the assessment for the audit area as a whole might result in performing insufficient audit procedures as they relate to the assertions with higher risk. Likewise, a "high" risk assessment for the audit area as a whole might result in overauditing certain assertions and a less efficient audit. For significant audit areas where the auditor has identified one or more specific risks, the risk assessment needs to be documented at the assertion level. When the auditor documents the risk assessment at the assertion level, an assessment is made and documented for each relevant assertion regardless of whether the auditor has identified any specific risks related to that assertion.

Assessing Inherent Risk. As discussed earlier in this lesson, inherent risk is the susceptibility of a relevant assertion about a class of transactions, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there are no related controls. If control risk is assessed as high, which might often be the case, the inherent risk assessment may be the only variable that determines the risk of material misstatement. Accordingly, the inherent risk assessment can significantly affect the auditor's planned further audit procedures.

Inherent risk is higher for some assertions and related account balances, classes of transactions, and disclosures than for others. Considering inherent risk factors involves contemplation of the influence of the environment and the nature of the items comprising an account balance, transaction class, or disclosure on the possible occurrence of material misstatements, whether caused by error or fraud, in the financial statements. Unlike the control risk assessment, which requires tests of controls for assessment of risk below a high level, inherent risk assessment is an intuitive process based on the auditor's knowledge of the client and audit area. For example, an auditor of a manufacturing client that has material financial statement balances in inventory and property might assess inherent risk higher for assertions related to inventory than for assertions related to property. Even if both of the accounts have material financial statement balances and are considered significant audit areas, inventory has a high level of activity throughout the year and is typically significant to financial statement users of a manufacturing company. In contrast, the balance in the property account is made up primarily of transactions that occurred and were audited in prior years.

The inherent risk assessment is made before consideration of related controls. Factors such as the following might be considered by the auditor in assessing inherent risk:

a. *Engagement Risk.* The effect of previously identified risk factors at the financial statement or engagement level.

b. *Accounting Issues.* The complexity and contentiousness of accounting issues.

c. *Auditing Issues.* The frequency or significance of difficult-to-audit transactions or disclosures.

d. *Prior Period Misstatements.* The nature, cause, and materiality of misstatements detected in prior audits.

e. *Susceptibility to Fraud.* The susceptibility to fraud, including both misappropriation of assets and fraudulent financial reporting.

f. *Accounting Personnel.* The competence and experience of personnel assigned to process data or make decisions.

g. *Need for Judgment.* The extent of judgment or estimates involved. For example, accounting estimates require more judgment than account balances that represent a total of exchange transactions.

h. *Nature of Items.* The size and volume of items comprising the account balances or transaction classes.

i. *Complexity.* The complexity of calculations. For example, the LIFO method requires more complex calculations than specific identification.

Some common examples of inherent risk considerations are as follows:

a. Complex calculations are more likely to be misstated than simple ones.

b. Cash is more susceptible to theft than coal inventory.

c. Accounts composed of amounts based on accounting estimates involve more risk than accounts consisting of routine transactions.

Examples of external factors that might affect inherent risk are as follows:

a. Technological developments might make a particular product obsolete, causing inventory to be more susceptible to overstatement.

b. Insufficient working capital or a declining industry with numerous business failures may affect the tendency of many or all balances or transaction classes to be misstated.

Example 1-12 illustrates the auditor's inherent assessment.

Example 1-12: Inherent risk assessment.

PFL Sporting Goods is a wholesale distributor of athletic equipment to small sporting goods retailers. PFL has been an audit client for over 10 years, and the auditor is planning the audit of accounts receivable for the current fiscal year. As part of the planning process, the auditor assesses inherent risk for accounts receivable based on the following:

1. The presumption that improper revenue recognition is a fraud risk cannot be overcome for PFL. The auditor determines that the risk relates to overstatement (existence or occurrence) of revenue rather than understatement (completeness) because of the entity's debt covenants. Since this is a fraud risk, the auditor assesses inherent risk for existence or occurrence as high, but the risk for completeness is low (sales are not difficult to capture and all sales are for credit rather than cash).

2. Some of PFL's customers want to minimize their inventory levels after the Christmas selling season, so they request that shipments be held until January. Since PFL is motivated to overstate sales, which could be accomplished by recognizing revenue for goods that have not been shipped, the auditor assesses inherent risk for cutoff as high.

3. PFL's bad debt experience varies with the local economy, especially the Christmas season, and is somewhat difficult to predict. Thus, the allowance for doubtful accounts is a very subjective estimate. Therefore, the auditor assesses inherent risk for valuation as high.

4. PFL does not have a lot of related party relationships or transactions and there is nothing complex about determining who has rights or title to receivables and sales. Therefore, the auditor assesses inherent risk for rights or obligations as low.

5. There is a large volume of sales and receivables transactions and year-end is especially significant due to the Christmas selling season. However, although the size and volume of the sales and receivables accounts are material, they are comprised of only a few large accounts and a large number of very small accounts, making it difficult to accumulate enough accounting errors related to accuracy or classification to result in a material misstatement. There is nothing complex about determining the proper amount of a transaction to record or the appropriate account since PFL uses very few different sales and receivables accounts. There are no significant credit balances in accounts receivable at the end of the year. Based on the size and volume of transactions and balances, however, the auditor assesses inherent risk for accuracy or classification as moderate.

The auditor's evaluation of inherent risk might indicate whether the related account is most likely to be overstated or understated. For example, the auditor's evaluation of inherent risk factors might result in a determination that inventory is more likely to be overstated while accounts payable is more likely to be understated. By understanding the likely direction of the inherent risk for assertions related to an account or class of transactions, the auditor is better able to evaluate related control design and plan and perform further audit procedures. In most audits, there is a primary direction of overall inherent risk, resulting primarily from factors related to the use of the financial statements, that tends to influence management's judgments related to selecting accounting policies or making estimates.

Documenting the Inherent Risk Assessment. The auditor can indicate either high, moderate, or low when documenting the inherent risk assessment. Inherent risk assessment is an intuitive process based on the auditor's knowledge of the client and related audit area. Generally including a few comments about the nature of the audit area and related assertions will normally be sufficient. As discussed later in this section, the auditor is permitted to make an overall, or combined, assessment of the risk of material misstatement at the assertion level. Alternatively, the auditor can make separate assessments of inherent risk and control risk and then combine them. The auditor can document the basis for the inherent risk assessment by (a) identifying factors that significantly affect inherent risk and (b) indicating how those factors affect the auditor's assessment.

Assessing Control Risk. The next step is for the auditor to make a qualitative evaluation of control risk as high, moderate, or low. One option is for the auditor to take a top-down approach, considering information gathered during risk assessment. The auditor begins with the financial statements and identifies the significant classes of transactions, account balances and disclosures. The significant transaction classes and processes that result in those account, balances and disclosures are identified next. Within those transaction classes and processes, the auditor further identifies the controls that individually or in combination with other controls prevent, or detect and correct, material misstatements in the relevant assertions related to identified risks. It is important to consider company-wide, or entity-level, controls as well as control activities because entity-level controls are often very efficient to test.

If mitigating controls are identified, the auditor then decides whether or not to test those controls for operating effectiveness to support a reduced control risk assessment. As discussed in Lesson 2, the decision about whether to test controls is based on consideration of both audit effectiveness and efficiency. If the auditor decides to test controls, consideration ought to be given to whether the procedures already performed to evaluate the design of controls and determine that they have been implemented also provide evidence about the operating effectiveness of controls. It may be possible to support a control risk assessment of moderate based on procedures performed to evaluate the design of controls and determine that they have been implemented, depending on the degree of assurance about operating effectiveness provided by these procedures. However, such procedures generally will not support a control risk assessment of low unless there is some automation that provides for the consistent application of the control. In some limited situations where a control operates only once a year, the auditor may determine that risk assessment procedures related to the design and implementation of the control may provide sufficient audit evidence to support a control assessment of low. For example, if the auditor obtains sufficient evidence about the design and implementation of a relevant control that occurs once a year in the annual physical inventory count or goodwill impairment evaluation, such procedures may support a low control risk assessment. See further discussion on how procedures that are performed to evaluate the design and implementation of internal control can also be used as tests of operating effectiveness in Lesson 2.

If tests of the operating effectiveness of controls are performed to support a reduced assessed level of control risk, the auditor should document those tests. Controls can be listed by transaction class within each audit area to gain a further understanding of the design and implementation of controls and to indicate the controls, if any, the auditor plans to test.

Based on the evaluation of mitigating controls and consideration of the results of procedures performed to support the control risk assessment, the auditor then evaluates control risk and documents it in the qualitative categories of high, moderate, or low. The auditor's assessment of control risk as high, moderate, or low should be supported by the procedures performed. Often, the risk assessment summary is documented before planned tests of controls are actually performed. In that case, the control risk assessment documented on the form is the preliminary assessed level of control risk that the auditor plans to support by performing the control tests. If the results of the tests of controls do not support that planned assessment, the auditor needs to revise the assessment and reconsider the effect on the audit approach. As previously discussed, the auditor cannot support a reduced control risk assessment without obtaining evidence of operating effectiveness.

Documenting the Control Risk Assessment. As indicated in the previous paragraph, the auditor can indicate either high, moderate, or low when documenting the control risk assessments. (The auditor needs to remember that a control risk assessment of less than high should be supported by tests of the operating effectiveness of controls. Reliance on procedures performed when evaluating internal control design and implementation is only appropriate if assurance about the operating effectiveness of controls throughout the period under audit has been obtained. Ordinarily, it does not seem likely that such risk assessment procedures will be sufficient to support a control risk assessment below moderate.)

Assessing the Combined Risk of Material Misstatement. The risk of material misstatement (RMM), the product of IR and CR, is the auditor's *combined* assessment of the two risks. The risk assessment standards permit the auditor to make an overall, or combined, assessment of the risk of material misstatement at the assertion level. Alternatively, the auditor can make separate assessments of inherent risk and control risk and then combine them. The auditor evaluates the remaining specific risk of material misstatement (combination of inherent risk and control risk) as high, moderate, or low. The table in Exhibit 1-12 can assist auditors in determining the combined assessed risk of material misstatement when the auditor makes separate assessments of inherent risk and control risk. A nonauthoritative Technical Question and Answer (Q&A 8200.09), *Assessing Inherent Risk*, notes that control risk is always considered in the assessment of the combined risk of material misstatement even if inherent risk is assessed as low. As addressed in the "General Audit Engagement Checklist" included in the AICPA Peer Review Program Manual, if the risk of material misstatement for any relevant assertions or significant accounts indicates that inherent risk is less than high, the auditor needs to have a reasonable basis for that assessment after considering documented engagement team discussions, the key elements of the auditor's understanding of the various aspects of the entity and its environment, any significant decisions made, and a separately documented inherent risk assessment, if prepared.

Exhibit 1-12

Combining Inherent Risk and Control Risk

Inherent Risk	Control Risk	=	Risk of Material Misstatement[a]
High	High		High
High	Moderate		High
High	Low		Moderate
Moderate	High		Moderate
Moderate	Moderate		Low
Moderate	Low		Low
Low	High		Low
Low	Moderate		Low
Low	Low		Low

Note:

[a] How the auditor combines inherent and control risk to assess the risk of material misstatement is subject to auditor judgment.

* * *

Documenting the Combined Risk Assessment (RMM). The auditor can document the combined assessed risk of material misstatement as high, moderate, or low.

Documenting the Risk of Material Misstatement. AU-C 315.33 requires the auditor to document the assessment of the risk of material misstatement at the relevant assertion level. Auditors also are required to document any fraud risks or other significant risks they identify.

Responding to the Risk Assessment. The purpose of the risk assessment is to determine the nature, timing, and extent of further audit procedures to be performed. For simplicity in the discussions throughout this course, the overall decision of which further audit procedures will be performed is referred to as the selection of an audit "approach." An *approach* is defined as "the method used or steps taken in setting about a task, problem, etc." In this course, the approach selected by the auditor to respond to the risk assessment and documented for each audit area is whether to:

- Perform only limited procedures and not develop a separate audit program,
- perform basic procedures from the core audit program,
- perform basic procedures plus certain extended procedures from the core audit program, or
- perform procedures on the specified risk audit program.

The PPC audit approaches are illustrated in Exhibit 1-13:

Exhibit 1-13

PPC Audit Approaches

Limited Procedures	• No audit program • Used for insignificant audit areas with low RMM
Basic Procedures	• Primarily substantive analytics • Some tests of details (required by GAAS)
Basic + Extended Procedures	• Tests of details and extended analytics • For audit areas or assertions with higher risk
Specified Risk	• Pre-defined set of risks and responses for smaller entities

* * *

Limited Procedures Approach. The auditor first considers whether the preliminary analytical procedures and other risk assessment procedures performed during initial planning and the final analytical procedures performed in the overall review stage of the audit provide enough assurance that no further audit procedures are considered necessary. In other words, no separate specific audit program is needed for the audit area because the procedures for performing preliminary analytics, other risk assessment procedures, and final analytics are included in the general programs. That approach is referred to as the Limited Procedures approach and will generally be appropriate only for audit areas that are not significant and have a low combined risk of material misstatement. For audit areas that are not significant but have a risk of material misstatement other than low or require audit attention for other reasons such as client expectations, an audit program might be needed. In addition, for significant audit areas, the auditor is required to perform some substantive procedures for each relevant assertion; therefore, an audit program is always needed for those areas.

Choosing between Core Audit Programs and Specified Risk Audit Programs. The next decision to be made by the auditor is whether to use the core audit programs or the specified risk audit programs for a particular audit area. Both sets of audit programs illustrated in *PPC's Guide to Audit Risk Assessment* (i.e., core and specified risk) provide a starting point for the auditor to use in developing an audit response and determining the nature, timing, and extent of further audit procedures that need to be performed to respond to the risk assessment. (*PPC's Guide to Audits of Nonpublic Companies* and certain other PPC audit guides for specialized industries provide a complete set of core and specified risk audit programs.) Both sets of the audit programs need to be tailored to respond to the individual risk assessment as discussed later in this lesson. The individual audit programs document audit procedures and the assertions relevant to each procedure and provide linkage to the assessed risk of material misstatement. The assessment of the risk of material misstatement by assertion assists the auditor when deciding on an appropriate audit response by providing linkage between the risks and related audit program procedures.

When deciding which approach is appropriate, it is important for the auditor to perform a careful review of the procedures in each program to ensure that the approach and the further audit procedures selected will appropriately respond to the assessed risk for a particular client. The key to audit effectiveness and efficiency is to choose an audit approach that adequately responds to the identified risks without requiring excessive time commitments.

Basic and Extended Procedures Approaches (Core). The PPC core audit programs illustrated in *PPC's Guide to Audit Risk Assessment* include both general audit programs and audit programs for specific financial statement audit areas. To assist auditors in tailoring their audit procedures to appropriately respond to the risk assessment, the core audit programs for individual audit areas include the following sections:

- *Basic Procedures*, which include primarily substantive analytical procedures and certain tests of details, most of which are required by GAAS (such as confirmation of receivables, inventory observation, and tests to address the risk of improper revenue recognition).

- *Extended Procedures (Procedures for Additional Assurance)*, which include procedures from which the auditor can choose one or more steps as necessary to supplement the basic procedures in response to the auditor's risk assessment at the relevant assertion level.

- *Other Audit Procedures*, which include procedures that may be warranted due to the specific circumstances of the engagement. (Other audit procedures are considered Extended Procedures for documentation purposes.)

Auditors using the core audit programs decide whether to apply basic or basic plus extended procedures based on the risk assessment at the relevant assertion level. However, the analysis is not a simple determination based on whether that risk is high, moderate, or low. Usually, a low or moderate risk of material misstatement in a significant audit area means that a Basic Procedures approach may be appropriate for those assertions. However, the auditor also has to consider the expected cause and direction of potential misstatements, the relationships among audit areas, and whether the risks are fraud risks or other significant risks, as well as client expectations. The particular tests selected, whether they are in the Basic or Extended section of the audit programs, need to be tailored to the nature, cause, and direction of potential misstatements at the relevant assertion level. It may also be appropriate to alter the extent or timing of the procedures to adequately respond to the risk assessment.

As previously stated, the Basic Procedures section of the core audit programs contains certain tests of details, many of which are required by the auditing standards (such as confirmation of receivables, inventory observation, and tests to address the risk of improper revenue recognition). If applicable, the auditor performs those procedures. The performance of those procedures may also be a response to a higher assessed level of risk for the related assertions. In other words, those procedures may provide additional assurance even though they are included in the Basic Procedures section rather than in the Extended Procedures section.

The Extended Procedures section of the core audit programs, which includes procedures for additional assurance, is a source list of possible audit procedures. It is not an alternative audit program. It is arranged by topic and includes a column indicating the assertions that are primarily and secondarily addressed by the procedure. The auditor selects procedures from the list that are needed to respond to the risk assessment. Selecting appropriate substantive procedures is discussed more fully in Lesson 2.

A helpful process for selecting an audit approach using Limited, Basic, or Extended Procedures is to base the decision on the information documented previously for the following factors:

- Whether the audit area is significant.

- Whether the audit area contains any specifically identified risks.

- Whether an identified risk is considered to be a fraud risk or other significant risk.

- The assessed level of the risk of material misstatement.

For those circumstances when an Extended Procedures approach is used, extended procedures will normally be performed only for those assertions that are of concern to the auditor based on the assessed risk of material misstatement at the assertion level.

Specified Risk Approach. The specified risk set of audit programs was developed based on a set of underlying risk assumptions at the assertion level for most audit areas. The procedures in the specified risk audit programs come from the basic and extended procedures in the core audit programs. (All procedures in the specified risk programs are also in the core audit programs.) The programs include substantive procedures for general ledger account groupings common to many small, nonpublic companies. These programs are designed to increase audit efficiency by linking the financial statement assertions, risk assumptions, and procedures to identify those procedures that are common to many small, nonpublic audit engagements. Additional guidance on tailoring the specified risk audit programs is available later in this lesson.

At the front of each specified risk audit program is a description of the underlying risk assumptions for that audit area. Before selecting the specified risk approach and using the related programs, auditors ought to perform a careful review of the underlying risk assumptions and the procedures in each program to ensure that the further audit procedures selected appropriately respond to the assessed risk for a particular client. The description of underlying risk assumptions is not intended to be part of the audit documentation. The risk assessment for a particular client should be documented.

The procedures provided in the specified risk audit programs are intended to apply to small nonpublic entities or engagements that have the following general characteristics:

- The auditor does not intend to rely on the operating effectiveness of controls to reduce the control risk assessment. Substantive procedures alone are effective in responding to the risk assessment.

- Accounting personnel are generally competent to process data and make decisions necessary to perform their assigned duties.

- No fraud risks are identified except the risks of improper revenue recognition and management override of controls. The risk of management override of controls is addressed in the general audit program.

- There are no known significant deficiencies or material weaknesses in the control environment that would require modification of the programs.

- Audit procedures are either performed entirely at year end or are applied to transactions through an interim date and completed as part of year-end procedures (that is, audit conclusions are not extended from an interim date to the balance sheet date).

If the general characteristics above do not apply to the particular engagement, auditors need to consider whether it is appropriate to use the specified risk approach or whether the basic or extended procedures approach using the core audit programs ought to be used. If the risk assessment for a particular audit area or assertion differs from the assumed underlying risk assumptions, the auditor ought to consider the need to modify the audit program for that audit area or assertion to adequately respond to the risk assessment. If additional procedures are needed, they can be selected from the core audit programs. Additional guidance on tailoring the specified risk audit programs appears later in this lesson. In some cases, it may be possible to adequately respond to a particular risk assessment by altering the extent of procedures in the specified risk audit program rather than selecting additional procedures.

Documenting the Response. It is a good idea for the auditors to document which approach they have selected (Limited = "L", Basic = "B", Extended = "E", or Specified Risk = "S"). They may also want to include comments that might be appropriate concerning the audit program, including the linkage between risks and responses. Comments might include:

- Information that clarifies how the audit programs/procedures have been tailored to respond to the risk assessment.

- Information about the nature, timing, or extent of further audit procedures in response to other identified risks.
- Descriptions of the procedures that will be performed to specifically respond to fraud risks or other significant risks.
- Whether certain tests of details (included in the basic procedures) will be performed to respond to an identified risk.
- A reference to where tests of controls are performed.

Types of Substantive Procedures and Audit Strategies

The following paragraphs explain how to prepare efficient and effective audit programs. They discuss the basic types of substantive procedures, provide guidance on selecting an audit approach, and explain how to tailor audit programs such as the ones illustrated in *PPC's Guide to Audit Risk Assessment* for an efficient and effective audit.

Basic Types of Substantive Procedures. Substantive procedures have historically been classified and described based on their nature, for example, inspection, confirmation, or reperformance. This perspective is a sound approach to basic auditing, but it does not help auditors determine the most efficient procedures for responding to specific risks. See Lesson 2 for additional discussion of the types of substantive procedures.

Limited, Basic, and Extended Procedures. Some procedures are more effective than others, and some are more time-consuming than others. The key to audit efficiency and effectiveness is to choose procedures that adequately respond to the identified risks without requiring excessive time commitments. In the core audit programs, substantive procedures are grouped into the following categories based on the degree of detail involved:

- Limited procedures (preliminary analytical procedures, other risk assessment procedures, and final analytical procedures).
- Basic procedures.
- Extended procedures (procedures for additional assurance) and other audit procedures.

Exhibit 1-14 shows how the traditional substantive audit procedures fit into these categories. Note that some procedures may fit more than one category depending on how they are applied. For example, analytical procedures, which may be used to test any financial statement assertion, might be applied in any type of audit approach. On the other hand, reperformance, which is used primarily to test valuation or allocation but may be used to test existence, occurrence, or completeness, is generally used only as a procedure for additional assurance. The following paragraphs discuss each category of procedures in the context of the PPC audit approaches.

<u>Limited Procedures (Preliminary Analytical, Other Risk Assessment, and Final Analytical Procedures).</u> Limited procedures consist of performing preliminary analytics, other risk assessment procedures, and final analytics only. These procedures are included in the general audit programs and need to be performed on every engagement. Preliminary analytical procedures are normally simple analytical procedures, such as comparison of current and prior-year balances on the working trial balance or lead schedule. Limited procedures may also include inquiries of client personnel or other procedures to determine explanations for differences, as well as risk assessment procedures applied to obtain an understanding of the client's business and fraud risks, management's response to those risks, and their effect on the audit. In the overall review stage of the audit, similar analytical procedures are applied to the audited financial statement amounts. The Limited Procedures Approach is normally sufficient for areas in which audit risk is low, such as asset accounts with immaterial balances. However, AU-C 330.18 states that auditors should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. As a result, the limited procedures approach is not appropriate for material or otherwise significant audit areas.

Exhibit 1-14

Relationship of Substantive Audit Procedures to Audit Approach

	Related Assertions[a]		Audit Approach[b]		
Procedure	**Primary**	**Secondary**	**Limited Procedures**	**Basic Procedures**	**Extended Procedures**
Inquiry	All assertions[c]		3	3	3
Analytical procedures	All assertions		3	3	3
Observation[d]	All assertions			3	3
Inspection of tangible assets	E/O	A/CL, V, R/O		3	3
Confirmation[e]	E/O, R/O	C, A/CL, V, CO		3	3
Inspection of documents	All assertions			3	3
Reperformance and recalculation	A/CL, V, CO	E/O, C			3

Notes:

[a] E/O—existence or occurrence; C—completeness; R/O—rights or obligations; A/CL—accuracy or classification; V—valuation or allocation; CO—cutoff.

[b] Some procedures fit more than one category depending on how they are applied.

[c] Inquiry may need to be supported by more evidence. However, it is usually more efficient to corroborate responses to inquiries than to find answers independently through an undirected examination of detailed evidence.

[d] According to AU-C 501, unless it is impracticable, the auditor should make or observe physical counts. This course suggests that immateriality of inventory balances is the only reason not to observe or make physical counts of inventory. If inventory is not observed due to immateriality, it is a best practice for auditors to document that conclusion.

[e] AU-C 330.20 and AU-C 505.03 indicate that the auditor is required to use external confirmation procedures for accounts receivable unless certain specified conditions are met. Thus, there is a presumption that the auditor will request confirmation of accounts receivable during the audit unless certain conditions exist. If accounts receivable are not confirmed, AU-C 330.32 requires auditors to document how they overcame that presumption.

* * *

<u>Basic Procedures.</u> The basic procedures section of the audit programs includes primarily substantive analytical procedures and certain tests of details, most of which are required by specific AU-C sections. Analytical procedures

include more than just comparisons of recorded amounts to financial and nonfinancial information. Likewise, the basic procedures include such tasks as the following:

- Scanning accounting records to identify unusual relationships or the absence of expected relationships.
- Inquiring of the client about relevant audit matters.
- Observing certain assets or client practices.
- Confirming information with third parties and performing other limited detail tests.

The basic procedures are generally sufficient when the risk of material misstatement has been assessed as low or moderate. Often, these procedures are supplemented in higher-risk areas by extended procedures (procedures for additional assurance). Basic procedures by themselves are not ordinarily appropriate to respond to a fraud risk or other significant risk. However, the following are examples of areas where basic procedures may be appropriate to respond to high risks:

- *Observation of Inventory.* Observing inventory, which is a basic procedure in the audit program for inventory, may be an appropriate response to high risks related to the existence of inventory.
- *Confirmation of Receivables.* Confirming receivables, which is a basic procedure in the audit program for accounts receivable and sales, may be an appropriate response to high risks related to the existence of receivables.
- *Search for Unrecorded Liabilities.* A search for unrecorded liabilities, which is a basic procedure in the audit program for accounts payable and other liabilities, may be an appropriate response to high risks related to the completeness of liabilities.

In those cases, the auditor needs to carefully consider the extent and timing of the basic procedures when responding to the higher risk.

<u>Extended Procedures (Procedures for Additional Assurance).</u> By selecting the Extended Procedures approach, the auditor is stating that he or she will perform the basic procedures plus selected extended procedures (procedures for additional assurance) or other audit procedures. Extended procedures consist primarily of the following types of substantive procedures:

a. *Tests of Details.* These are procedures, such as vouching, tracing, reperformance, or confirmation, that are applied to individual transactions or balances. There are two primary types of tests of details:

   (1) *Tests of Transactions.* These are tests of the processing of individual transactions by inspection of the documents and accounting records involved in processing or reperforming client routines; for example, tracing a sample of shipping documents to the sales journal to see whether shipments have been recorded as sales.

   (2) *Tests of Balances.* These are tests applied directly to the details of balances in general ledger accounts, for example, confirming the balances of accounts in the accounts receivable subsidiary ledger with individual customers or recomputing depreciation. Generally, tests of balances are more efficient and effective than tests of transactions.

b. *Analytical Procedures.* These analytical procedures are similar to the limited procedures discussed above. However, they are performed at a higher level of precision. For example, they are typically performed at a very detailed (disaggregated) level. A discussion on choosing between analytical procedures and tests of details appears in Lesson 2.

These procedures generally provide a higher degree of audit assurance, so one or more procedures are normally selected to supplement the basic procedures when responding to a higher-risk area or assertion. This is discussed further below.

Specified Risk Approach. The specified risk programs have been developed from the basic and extended procedures in the core audit programs. (All procedures in the specified risk programs are also in the core audit programs.) Generally, the audit procedures in the specified risk programs are more focused on substantive tests of details versus substantive analytics. The programs have been developed based on a predefined set of risk assumptions and include procedures that may be typical in the audit of the financial statements of a small, nonpublic entity.

Tailoring the Audit Programs

Earlier sections of this lesson explain in detail how the auditor assesses risks in the audit. The auditor identifies risks (including risks of material misstatement due to fraud), considers management's response to those risks through operating decisions and controls, and assesses the risk of material misstatement at the relevant assertion level.

As previously noted, the key to efficient and effective auditing is selecting procedures for each audit area or assertion that correspond to its respective risks. Simply stated, this means spending more audit effort responding to the higher-risk areas or assertions and less audit effort in responding to the lower-risk areas or assertions. This section explains how to use the audit programs illustrated in *PPC's Guide to Audit Risk Assessment* and those included in all PPC audit guides for efficient auditing that meets the requirements of professional standards. Lesson 2 includes a more detailed discussion on the substantive procedures required by specific AU-C sections in every audit; the nature, timing, and extent of substantive procedures; and choosing between substantive analytical procedures and substantive tests of details.

Lower-risk Audit Areas or Assertions. In lower-risk areas or assertions, the auditor believes there is little chance that a material misstatement will occur and expending significant amounts of effort to perform further audit procedures in these areas generally is unnecessary. Normally, limited procedures or the basic procedures are sufficient. However, the determination of further audit procedures needed for a given situation is a matter of auditor judgment.

Higher-risk Audit Areas or Assertions. Generally, areas or assertions with a higher assessed risk of material misstatement require more assurance from substantive procedures. This is generally accomplished by supplementing the basic procedures with one or more extended procedures. The decision of which substantive procedures are appropriate to respond to a high risk of material misstatement is a matter of professional judgment. Lesson 2 discusses altering the extent or timing of the procedure rather than adding more procedures.

Format of the Audit Programs. There are two sets of audit programs that can be used in the PPC audit approach: core audit programs and specified risk audit programs. *PPC's Guide to Audits of Nonpublic Companies* provides a complete set of core and specified risk audit programs.

The core and specified risk audit programs provide two different starting points for auditors to use in developing an audit response and determining the nature, timing, and extent of further audit procedures that need to be performed in response to the risk assessment. The Observations and Suggestions at paragraph 5.37 of the AICPA Risk Assessment Audit Guide note the importance of modifying audit programs as necessary to ensure that substantive procedures are clearly linked to assessed risks. Both the core and specified risk audit programs can be easily tailored to respond to the individual risk assessment. It is important for the auditor to perform a careful review of the procedures in each program when deciding which program to start with for a particular client or audit area.

Core Audit Programs. The PPC core audit programs include both general audit programs and audit programs for individual financial statement audit areas. The general procedures programs consist of the following sections:

- *General Planning Procedures*, including engagement acceptance procedures, the procedures for obtaining an understanding of the entity and its environment, including internal control, assessing the risk of material misstatement, determining planning materiality, etc.

- *Other General Planning Procedures*, including planning procedures related to matters such as using the work of specialists, group audits, and use of service organizations.

- *General Auditing and Completion Procedures*, including procedures required by specific AU-C sections that do not relate to particular account balances, such as testing of journal entries, evaluation of misstatements, and obtaining legal representation letters.

- *Other General Auditing and Completion Procedures*, including procedures that may be warranted, due to special circumstances such as voluntary disclosures in financial statements, environmental remediation liabilities, potential fraud or violations of laws and regulations, omitted procedures or subsequent discovery of facts, etc.

Each audit program for the individual audit areas generally consists of basic procedures, extended procedures (procedures for additional assurance), and other audit procedures. The differences in those sections were discussed earlier in this lesson.

The audit programs for general procedures cover the general steps performed in any audit. Any necessary tailoring generally involves removing or adding procedures to fit the specific circumstances of the engagement.

The audit programs for individual financial statement audit areas are designed to correspond with the auditor's risk assessments and decisions about the audit approach at the assertion level. The auditor can document significant audit areas, the risks of material misstatement affecting each area (including fraud risks or other significant risks), the assessment of those risks at the assertion level, the planned audit approach that is appropriately tailored to respond to the assessed level of risk, and the linkage of the assessed risks to the audit procedures that respond to those risks. To tailor the audit programs, the auditor first decides whether extended procedures are needed.

Selecting Extended Procedures (Procedures for Additional Assurance). If the auditor decides that extended procedures are needed, the next step is to decide which procedure(s) need to be performed. The auditor ought to select procedures that are most appropriate to respond to the risk assessment. The auditor uses the assertions to link the risks with the procedures. To help auditors in selecting appropriate procedures and to show linkage between the assessed risk and the further audit procedures performed to respond to the risk, each procedure on the audit programs indicates the assertions that are primarily and secondarily addressed by that procedure. Also, the auditor indicates the choice of a procedure by placing a checkmark in the box provided. Some extended procedures are specifically identified for consideration in response to identified fraud risks. If the auditor feels that the risk of material misstatement is still present after performing procedures or if there is not a procedure in the audit program that responds to the identified risk, the auditor needs to develop an appropriate response by editing or adding audit program steps.

The selection of extended procedures needed to respond to a particular risk is a matter of auditor judgment. When making those decisions, the auditor considers the factors discussed in Lesson 2. Even high-risk areas or assertions can be overaudited. Only rarely would an auditor need to perform all the extended procedures for an audit area. The auditor focuses on the extended procedures that relate to the risks identified for that area and, as previously noted, the auditor selects additional procedures based on the assessment of risk of material misstatement at the relevant assertion level. In some cases, only one additional procedure may be necessary. At other times, two or more procedures might be needed.

When the auditor is selecting extended procedures, the goal is to find the appropriate mix of analytical procedures and tests of details to respond to the risk of material misstatement. For high risk areas or assertions, the auditor generally chooses one or more extended procedures to supplement the basic procedures. However, sometimes the selected steps in the extended procedures section might replace one of the steps in the basic procedures section. The auditor need not apply certain procedures in the basic procedures section if other planned procedures are sufficient to reduce the risk of material misstatement to an appropriately low level.

Specified Risk Audit Programs. The specified risk programs have been developed from the basic and extended procedures in the core audit programs. (All procedures in the specified risk programs are also in the core audit programs.) Generally, the audit procedures in the specified risk programs are more focused on substantive tests of details versus substantive analytics. The programs have been developed based on a predefined set of risk assumptions and include procedures that are typical in a small, nonpublic engagement. If the general characteristics listed earlier in this lesson do not apply to the engagement, the auditor considers whether it is appropriate to use the core audit programs instead, or a combination as discussed later in this section.

The specified risk programs include, similar to the core audit programs, both general audit programs and audit programs for individual financial statement audit areas. The general procedures program consists of general planning procedures and the general auditing and completion procedures. Those sections were discussed earlier in this lesson. The other general planning procedures and other general auditing and completion procedures are not included in the specified risk programs. If the auditor has a particular circumstance covered in the additional sections of the general audit programs, he or she will need to go to the core programs and pull in the steps needed to fit the specific circumstances of the engagement.

The audit programs for the individual audit areas in the specified risk programs consist of one set of procedures, developed from the basic and extended procedures in the core audit programs. At the front of each specified risk audit program is a description of the underlying risk assumptions for that audit area. Before selecting the specified risk approach and using the related programs, the auditor performs a careful review of the underlying risk assumptions and the procedures in each program to ensure that the audit procedures included in the program appropriately respond to the risk assessment for a particular client or audit area.

If the risk assessment for a particular audit area or assertion differs from the assumed underlying risk assumptions, the auditor considers the need to modify the audit program for that audit area or assertion to adequately respond to the risk assessment. If additional procedures are needed, they can be selected from the basic, extended, and other procedures included within the core audit programs. As discussed in detail in Lesson 2, in some cases, it may be possible to adequately respond to a particular risk assessment by altering the extent or timing of procedures rather than selecting additional procedures. Also, as noted previously, depending on the assessed risks, the auditor might need to edit or add other audit program steps for an adequate audit response.

Can the Auditor Use a Combination of Core Audit Programs and Specified Risk Audit Programs? The answer is "Yes." There may be circumstances where the auditor decides to use a combination of core audit programs and specified risk audit programs for different audit areas. For example, assume the auditor has performed the risk assessment, performed a thorough review of the assumptions and procedures in the specified risk audit programs, and decided that the specified risk approach appropriately responds to the risk assessment for the client in all audit areas except Accounts Receivable (A/R). In that case, the auditor could use the specified risk programs for all of the audit areas except A/R. For A/R, the auditor would develop the audit program for receivables from the core audit programs and indicate on the risk assessment summary form that either a basic or extended procedures approach was selected for A/R.

Are the Audit Programs Illustrated in *PPC's Guide to Auditor's Reports* Considered "Canned" Audit Programs? The answer is "No." Practically, every auditor has to start with something when developing the audit plan and determining the nature, timing, and extent of further audit procedures that should be performed to respond to the risk assessment. The audit programs illustrated in *PPC's Guide to Auditor's Reports* are standardized programs that can be easily tailored to respond to the risk assessment. The individual audit programs document audit procedures and the assertions relevant to each procedure. The procedures have been separated into three categories—basic, extended, and other. Also, the extended procedures section of each program includes a box for the auditor to indicate the choice of a procedure by placing a checkmark in it. In addition, a form is provided to document the assessed risks by assertion and the audit approach selected to respond to the risks. It provides space for comments, as considered necessary, to clarify how the audit programs/procedures have been tailored to respond to the risk assessment.

Likewise, the specified risk audit programs provide the auditor with a starting point that considers a predefined set of risk assumptions typical of many small, nonpublic engagements. As noted above, if the risk assessment for a particular client differs from these assumptions, the auditor considers the need to modify the programs to be responsive to the risks. To assist the auditor in making decisions about tailoring, the specified risk assumptions are detailed at the beginning of each program in PPC's audit guides.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

8. Which of the following statements best describes an aspect of the detailed audit plan?

   a. Preliminary audit procedures are designed as part of the plan to respond to the risks of material misstatement at the relevant assertion level.

   b. The audit plan should include a description of the nature and extent of planned risk assessment procedures.

   c. Once finalized and documented, the audit plan should stay the same so as to provide consistency to the audit engagement.

   d. Minimizing time spent on audit procedures described in the audit plan is the primary way to increase audit efficiency.

9. Which auditor would assess risk of material misstatement as high?

   a. Elena has low inherent risk and moderate control risk.

   b. Fred has moderate inherent risk and high control risk.

   c. Grace has high inherent risk and low control risk.

   d. Howard has high inherent risk and moderate control risk.

10. When using the core PPC audit programs, which of the following includes procedures that are warranted because of an engagement's specific facts and circumstances?

    a. Limited procedures.

    b. Basic procedures.

    c. Extended procedures.

    d. Other audit procedures.

11. Which procedure can be used in the limited, basic, and extended audit approaches?

    a. Inquiry.

    b. Observation.

    c. Confirmation.

    d. Recalculation.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

8. Which of the following statements best describes an aspect of the detailed audit plan? **(Page 42)**

   a. Preliminary audit procedures are designed as part of the plan to respond to the risks of material misstatement at the relevant assertion level. [This answer is incorrect. Per AU-C 330.06, the auditor should design and perform *further audit procedures* (not preliminary audit procedures) responsive to the assessed risks of material misstatement at the relevant assertion level.]

   b. The audit plan should include a description of the nature and extent of planned risk assessment procedures. [This answer is correct. AU-C 300.09 indicates that the auditor should develop an audit plan that includes a description of (1) the nature and extent of planned risk assessment procedures; (2) the nature, timing, and extent of planned further procedures at the relevant assertion level; and (3) other planned procedures required by GAAS.]

   c. Once finalized and documented, the audit plan should stay the same so as to provide consistency to the audit engagement. [This answer is incorrect. AU-C 300.10 notes that the auditor should update and change the audit plan as needed during the audit.]

   d. Minimizing time spent on audit procedures described in the audit plan is the primary way to increase audit efficiency. [This answer is incorrect. There are many ways to increase audit efficiency while maintaining audit effectiveness. Many auditors focus on trying to minimize time spent performing audit procedures. Although this is important, it addresses only part of the process. It is also critical to choose audit procedures that effectively and efficiently accomplish the auditor's objectives.]

9. Which auditor would assess risk of material misstatement as high? **(Page 49)**

   a. Elena has low inherent risk and moderate control risk. [This answer is incorrect. Based on these risk levels, Elena should assess the risk of material misstatement for her engagement as low.]

   b. Fred has moderate inherent risk and high control risk. [This answer is incorrect. Based on these risk levels, risk of material misstatement in Fred's engagement should be assessed at moderate.]

   c. Grace has high inherent risk and low control risk. [This answer is incorrect. According to these risk levels, Grace should assess risk of material misstatement as moderate in this engagement.]

   d. Howard has high inherent risk and moderate control risk. [This answer is correct. The risk of material misstatement, the product of inherent risk and control risk, is the auditor's *combined* assessment of the two risks. Risk of material misstatement will be high if the inherent risk and control risk are both high. Risk of material misstatement will also be assessed at high if the inherent risk is high and the control risk is moderate. Therefore, Howard has chosen an appropriate level of risk of material misstatement based on the assessed levels of inherent risk and control risk in his engagement.]

10. When using the core PPC audit programs, which of the following includes procedures that are warranted because of an engagement's specific facts and circumstances? **(Page 51)**

    a. Limited procedures. [This answer is incorrect. This approach is used when no separate specific audit program is needed for the audit area because the procedures for performing preliminary analytics, other risk assessment procedures, and final analytics are included in the general programs. Therefore, the auditor would not need to use one of the three core PPC audit programs.]

    b. Basic procedures. [This answer is incorrect. This PPC core audit program includes primarily substantive analytical procedures and certain tests of details, most of which are required by GAAS (such as confirmation of receivables, inventory observation, and tests to address the risk of improper revenue retention).]

c. Extended procedures. [This answer is incorrect. These are procedures the auditor can choose, as needed, to supplement the basic procedures in response to the risk assessment at the relevant assertion level.]

d. Other audit procedures. [This answer is correct. According to the PPC core audit programs, *other audit procedures* include procedures that may be warranted due to the specific circumstances of the engagement.]

11. Which procedure can be used in the limited, basic, and extended audit approaches? **(Page 54)**

a. Inquiry. [This answer is correct. Inquiry and analytical procedures are the two types of procedures that can be used in the limited, basic, and extended approaches. They also can be used for all assertions.]

b. Observation. [This answer is incorrect. Observation is acceptable in both the extended and basic procedures approaches, but it is not used in the limited procedures approach.]

c. Confirmation. [This answer is incorrect. Confirmation is used in the basic and extended procedures approaches, but not in the limited procedures approach.]

d. Recalculation. [This answer is incorrect. Reperformance and recalculation are only used in the extended procedures approach.]

Lesson 2: Further Audit Procedures and Other Matters

INTRODUCTION

As mentioned in Lesson 1, the understanding of the entity and its environment, including its internal control and the auditor's risk assessment, are used in selecting further audit procedures responsive to risks of material misstatement at the relevant assertion level. This lesson discusses further audit procedures, which include tests of controls and substantive procedures. Substantive procedures include tests of details and substantive analytical procedures.

This lesson begins with a discussion of tests of the operating effectiveness of controls, including circumstances when tests of controls would be effective and circumstances when testing controls would be unnecessary or inefficient. The section includes an explanation of the nature of tests of controls, including inquiry and observation, inspection of documents, walkthroughs, review of reconciliations and similar bookkeeping routines, and reperformance of control activities. It also includes explanations of other considerations that are relevant when a decision is made to test controls, including the use of sampling in tests of controls, rotation of tests of controls when evidence from prior audits is used, efficiency opportunities in testing controls, documentation requirements, and the timing and extent of tests of controls.

Next this lesson gives guidance on making a control risk assessment, including guidance on considering the amount of audit evidence necessary to support a reduced control risk assessment and the effect of the control risk assessment on substantive procedures.

Finally, this lesson concludes with a discussion of substantive procedures, including substantive procedures required in every audit; the nature, timing, and extent of substantive procedures; selecting appropriate substantive procedures; and choosing between analytical procedures and substantive tests of details.

Learning Objectives:

Completion of this lesson will enable you to:
- Determine the appropriate procedures for tests of controls.
- Recognize how to evaluate tests of controls and assess control risks.
- Identify the best methods for dealing with substantive procedures.

AUTHORITATIVE LITERATURE

Tests of Controls

The authoritative pronouncements that establish requirements or provide guidance that most directly affects tests of controls are as follows:

a. AU-C 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, discusses how the results of tests of controls may affect the preliminary risk assessment and planned audit procedures.

b. AU-C 330, *Performing Audit Procedures in Response to Assessed Risk and Evaluating the Audit Evidence Obtained*, provides guidance on (1) how the preliminary risk assessment affects the design of further audit procedures, including tests of controls, (2) determining when tests of controls may be appropriate, (3) the nature, timing, and extent of control tests, (4) selecting items for testing, (5) evaluating the sufficiency and appropriateness of audit evidence collected, and (6) documentation requirements.

c. AICPA Audit Guide, *Assessing and Responding to Audit Risk in a Financial Statement Audit* (AICPA Risk Assessment Audit Guide), provides guidance on performing further audit procedures, including tests of controls.

Substantive Procedures

The authoritative pronouncements establishing requirements that most directly affect designing substantive procedures are as follows:

a. AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, requires the auditor to identify and assess risks of material misstatement due to fraud, and to design the audit to provide reasonable assurance of detecting fraud that results in the financial statements being materially misstated.

b. AU-C 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, discusses how the results of substantive procedures may affect the preliminary risk assessment and planned audit procedures.

c. AU-C 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, addresses designing and performing audit procedures that are responsive to risks at the relevant assertion level.

d. AU-C 500, *Audit Evidence*, describes audit procedures used to obtain audit evidence.

e. AU-C 505, *External Confirmations,* explains the auditor's use of external confirmation procedures to obtain audit evidence.

f. AU-C 520, *Analytical Procedures*, explains the use of analytical procedures as substantive tests to obtain sufficient appropriate audit evidence.

Objectives and Requirements

Objective—Tests of Controls. When the auditor performs audit procedures (including tests of controls), the objective is to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement by designing and implementing appropriate responses to those risks.

Requirements—Tests of Controls. The requirements that should be met to achieve that objective with respect to tests of controls are summarized in Exhibit 2-1.

Exhibit 2-1

Requirements for Tests of Controls

Requirements	AU-C Reference
When designing further audit procedures, consider the reasons for the assessed risk of material misstatement for relevant assertions for each transaction class, account balance, and disclosure, including whether the risk assessment takes into account relevant controls, thereby requiring audit evidence to determine whether the controls are operating effectively.	AU-C 330.07
Test the operating effectiveness of controls when: • The risk assessment includes an expectation that controls are operating effectively (that is, reliance is planned), or • substantive procedures alone are not sufficient.	AU-C 330.08
In designing and performing tests of controls:	
• Obtain more persuasive audit evidence the greater the reliance on controls.	AU-C 330.09

Requirements	AU-C Reference
• Perform other procedures in combination with inquiry to obtain evidence of: •• How controls were applied at relevant times during the period. •• The consistency with which the controls were applied. •• By whom and by what means the controls were applied, including whether the person performing them has the necessary authority and competence.	AU-C 330.10
• Determine whether audit evidence about the operating effectiveness of indirect controls is necessary (when the controls to be tested depend on other controls).	AU-C 330.10
Test controls for a particular time or throughout the period of intended reliance.	AU-C 330.11
If controls are tested at an interim date, obtain audit evidence about significant changes to those controls after the interim period and determine what additional evidence should be obtained for the remaining period.	AU-C 330.12
When deciding whether to use audit evidence from tests of controls performed in previous audits and, if so, how long to wait before retesting, consider the following: • Effectiveness of other elements of internal control, including the control environment, monitoring, and the entity's risk assessment process. • Whether the control is manual or automated, and other risk characteristics. • Effectiveness of general IT controls. • Effectiveness of the control and its application, including the nature and extent of deviations detected in previous audits and changes in personnel applying the control. • Whether the lack of change in a control when circumstances have changed poses risks. • Risks of material misstatement. • Extent of intended reliance on the control.	AU-C 330.13
Perform inquiry procedures, combined with observation or inspection, to establish the continuing relevance of tests of controls performed in previous audits and— • If there have been changes that affect the continuing relevance of previous audit evidence, test the controls in current audit. • If there have not been changes that affect the continuing relevance of previous audit evidence, test the controls at least once every third audit. • Test some controls during each audit; that is, do not test all controls in a single audit with no testing in the subsequent two audits.	AU-C 330.14
When testing controls over significant risks, test their operating effectiveness in the current audit.	AU-C 330.15
Evaluate whether misstatements detected by substantive procedures indicate that controls are not operating effectively.	AU-C 330.16
If deviations are detected, make specific inquiries to understand the reasons and their potential consequences and determine whether— • there is an appropriate basis for reliance on the controls, • additional tests of controls are necessary, or • potential risks of material misstatement need to be addressed using substantive procedures.	AU-C 330.17
Determine the means of selecting items for testing that are effective in meeting the purpose of the audit procedure.	AU-C 330.25
If audit evidence obtained from performing further audit procedures (tests of controls) is inconsistent with audit evidence on which the original risk assessment was based, revise the risk assessment and modify further planned audit procedures accordingly.	AU-C 315.32

Requirements	AU-C Reference
Document the following: • Nature, timing, and extent of further audit procedures (tests of controls) performed. • Linkage of further audit procedures (test of controls) with the assessed risks (control risk) at the relevant assertion level. • Results of audit procedures (tests of controls), including conclusions reached if not otherwise clear.	AU-C 330.30
If using audit evidence about the effectiveness of controls obtained in previous audits, document conclusions reached about relying on such controls.	AU-C 330.31

* * *

Objectives—Substantive Procedures. The objectives of the auditor when obtaining audit evidence and when designing substantive procedures, including analytical procedures, are as follows:

- To design and perform audit procedures that will obtain sufficient appropriate audit evidence to draw reasonable conclusions as a basis for the auditor's opinion.

- To obtain sufficient appropriate audit evidence about the assessed risks of material misstatement of the financial statements by designing and implementing appropriate responses to those assessed risks.

- To obtain sufficient appropriate audit evidence about the assessed risks of material misstatement of the financial statements due to fraud by designing and implementing appropriate responses.

- To design and perform confirmation procedures to obtain relevant and reliable evidence.

- To obtain relevant and reliable audit evidence when using substantive analytical procedures.

Requirements—Substantive Procedures. The requirements that should be followed to achieve those objectives are summarized in Exhibit 2-2.

Exhibit 2-2

Requirements for Audit Evidence and Substantive Procedures

Requirements	AU-C Reference
Designing and Performing Substantive Procedures	
Irrespective of the assessed risk of material misstatement, design and perform substantive procedures for all relevant assertions for each material class of transactions, account balance, and disclosure.	AU-C 330.18
Perform substantive audit procedures related to the financial statement closing process, such as the following: • Agree or reconcile the financial statements with the underlying accounting records. • Examine material journal entries and other adjustments made when preparing the financial statements.	AU-C 330.21
If an assessed risk of material misstatement at the relevant assertion level is a significant risk, perform substantive procedures specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, perform some tests of details rather than relying solely on analytical procedures.	AU-C 330.22

Requirements	AU-C Reference
If substantive procedures are performed at an interim date, cover the remaining period by performing additional substantive procedures, or substantive procedures combined with tests of controls, for the intervening period that provide a reasonable basis for extending the audit conclusions from the interim date to period end.	AU-C 330.23
If unexpected misstatements are detected at an interim date, evaluate whether the related risk assessment and the planned nature, timing, or extent of substantive procedures covering the remaining period need to be modified.	AU-C 330.24
If audit evidence obtained from performing further audit procedures (substantive procedures) is inconsistent with audit evidence on which the original risk assessment was based, revise the risk assessment and modify further planned audit procedures accordingly.	AU-C 315.32
Document the following items relating to substantive procedures: • The nature, timing, and extent of substantive procedures. • The linkage of those procedures with the assessed risks at the relevant assertion level. • The results of the procedures.	AU-C 330.30
Demonstrate in the audit documentation that the financial statements agree or reconcile with the underlying accounting records.	AU-C 330.33
Audit Evidence	
Design and perform audit procedures that are appropriate in the circumstances for obtaining sufficient appropriate audit evidence.	AU-C 500.06
When designing and performing audit procedures, consider the relevance and reliability of the information that will be used as audit evidence.	AU-C 500.07
When using information produced by the entity, evaluate whether the information is sufficiently reliable, including as necessary (1) obtaining audit evidence about the accuracy and completeness of the information and (2) evaluating whether the information is adequately precise and detailed.	AU-C 500.09
If audit evidence from one source is inconsistent with evidence from another source or there are doubts about the reliability of audit evidence, determine what modifications or additions to audit procedures are necessary to resolve the matter and consider the effect on other aspects of the audit.	AU-C 500.10
Analytical Procedures	
Determine the suitability of particular substantive analytical procedures for given assertions, taking into account the assessed risks of material misstatement and tests of details, if any, for those assertions.	AU-C 520.05
Evaluate the reliability of data from which the expectation of recorded amounts or ratios is developed, taking into account the source, comparability, nature, and relevance of information available, and the controls over its preparation.	AU-C 520.05
Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise (taking into account whether substantive analytical procedures are to be performed alone or in combination with tests of details) to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.	AU-C 520.05
Determine the amount of any difference between recorded amounts and expected values that is acceptable without further investigation and compare the recorded amounts, or ratios developed from recorded amounts, with the expectations.	AU-C 520.05

Requirements	AU-C Reference
If analytical procedures identify fluctuations or relationships that are inconsistent with other information or that differ from expected values by a significant amount, investigate the differences by: • Inquiring of management and obtaining appropriate audit evidence to corroborate management's responses. • Performing other audit procedures as necessary in the circumstances.	AU-C 520.07
Document the following: • The expectation and the factors considered in its development when that expectation or those factors are not otherwise readily determinable from the audit documentation. • Results of the comparison of the recorded amounts, or ratios developed from recorded amounts, with the expectations. • Any additional auditing procedures performed to investigate fluctuations or relationships that are inconsistent with other information or that differ from expected values by a significant amount, and the results of those procedures.	AU-C 520.08
Consideration of Fraud in a Financial Statement Audit	
Design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement due to fraud at the assertion level.	AU-C 240.30
Address the risk of management override of controls separately from more specifically identifiable risks by designing and performing audit procedures to—	
• Test the appropriateness of journal entries recorded in the general ledger and entries made when preparing the financial statements. In designing and performing audit procedures for such tests—	AU-C 240.32
•• Obtain an understanding of the entity's financial reporting process and controls over journal entries and other adjustments, and the suitability of design and implementation of such controls.	AU-C 240.32
•• Make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments	AU-C 240.32
•• Consider fraud risk indicators, the nature and complexity of accounts, and entries processed outside the normal course of business.	AU-C 240.32
•• Select journal entries and other adjustments made at the end of a reporting period.	AU-C 240.32
•• Consider the need to test journal entries and other adjustments throughout the period.	AU-C 240.32
• Review accounting estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud. In performing this review—	AU-C 240.32
•• Evaluate whether the judgments and decisions made by management in making accounting estimates, even if they are individually reasonable, indicate a possible bias on the part of the entity's management that may represent a risk of material misstatement due to fraud. If so, reevaluate the accounting estimates taken as a whole.	AU-C 240.32
•• Perform a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year. Select estimates for review that are based on highly sensitive assumptions or are otherwise significantly affected by judgments made by management.	AU-C 240.32

Requirements	AU-C Reference
• Evaluate, for significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual given the understanding of the entity and its environment and other information obtained during the audit, whether the business rationale (or the lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets.	AU-C 240.32
Determine whether additional procedures are necessary in order to respond to the identified risks of management override of controls.	AU-C 240.33
Document the following as part of the auditor's responses to the assessed risks of material misstatement: • The nature, timing, and extent of audit procedures, and the linkage of those procedures with the assessed risks of material misstatement due to fraud at the assertion level. • The results of the audit procedures, including those designed to address the risk of management override of controls.	AU-C 240.44
Auditing Accounting Estimates	
For accounting estimates that give rise to significant risks, evaluate the following: • How management considered alternative assumptions or outcomes and why it rejected them or how management otherwise addressed estimation uncertainty in making the accounting estimate. • Whether the significant assumptions used by management are reasonable. • When relevant to the reasonableness of the significant assumptions used by management or the appropriate application of GAAP, management's intent and ability to carry out specific courses of action.	AU-C 540.15
If management has not adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks, develop a range to use in evaluating the reasonableness of the accounting estimate if considered necessary.	AU-C 540.16
For accounting estimates that give rise to significant risks, obtain sufficient appropriate audit evidence about whether the following are in accordance with GAAP: • Management's decision to recognize or not recognize the accounting estimates in the financial statements. • The selected measurement basis for the accounting estimates.	AU-C 540.17

* * *

DEALING WITH TESTS OF CONTROLS

As part of every financial statement audit, the auditor is required to obtain an understanding of internal control. AU-C 315.14 states that the understanding should include an evaluation of the design of controls and a determination of whether they have been implemented.

The evaluation of control design and implementation serves a different purpose than tests of controls (the subject of this section). The evaluation of control design and implementation, which is accomplished through the performance of risk assessment procedures, is necessary to assess the risk of material misstatement of the financial statements. As discussed in Lesson 1, the combined risk of material misstatement includes a control risk component. Based on that assessment, the auditor determines which further audit procedures to perform. Further audit procedures may include tests of the operating effectiveness of controls (that is, tests of controls), as well as substantive procedures.

Unlike the evaluation of control design and determination of implementation, which are required in every audit, tests of controls, which are categorized as further audit procedures, are *not* required in every audit. Tests of controls are performed when the auditor plans to rely on their operating effectiveness when designing substantive procedures.

As indicated in AU-C 330.A22, testing the operating effectiveness of controls is different from obtaining evidence that controls have been implemented. *Implementation* means that the controls exist and are being used. Operating effectiveness relates to how and by whom controls are applied and the means by which and consistency with which the controls are applied.

After testing controls, the auditor evaluates the sufficiency and appropriateness of audit evidence obtained and, based on that evidence, reaches a conclusion about the operating effectiveness of the controls tested. If necessary, the auditor modifies the initial control risk assessment (and combined risk of material misstatement) and reconsiders the nature, timing, and extent of planned substantive procedures.

Practical Considerations for Tests of Controls

Auditors may ask the following questions with respect to tests of controls, which are answered in the following paragraphs:

- When is it necessary or required to test controls?
- When is it not efficient to test controls?
- For what periods of time should tests of controls be performed?
- Can evidence obtained from tests of controls in previous audits be used in the current audit?
- What needs to be considered when testing computer application controls?
- How can controls be tested most efficiently?
- What are the documentation requirements related to tests of controls, and how can the auditor document tests of controls?
- If controls are tested, how extensive should the tests be? Also, how much evidence is necessary to reduce the control risk assessment to "moderate" or "low" rather than "high?"
- To what extent can the control risk assessment be reduced based on risk assessment procedures performed to understand the design and implementation of controls?
- How much audit effort can be saved by reducing the control risk assessment to "moderate" rather than "high?"

Basic Approach to Tests of Controls

The following basic steps normally apply when considering tests of controls and are discussed further later in this lesson:

Step 1 Identify audit areas where tests of controls are necessary or efficient.

Step 2 Decide which controls to test.

Step 3 Select appropriate procedures.

Step 4 Perform tests of controls.

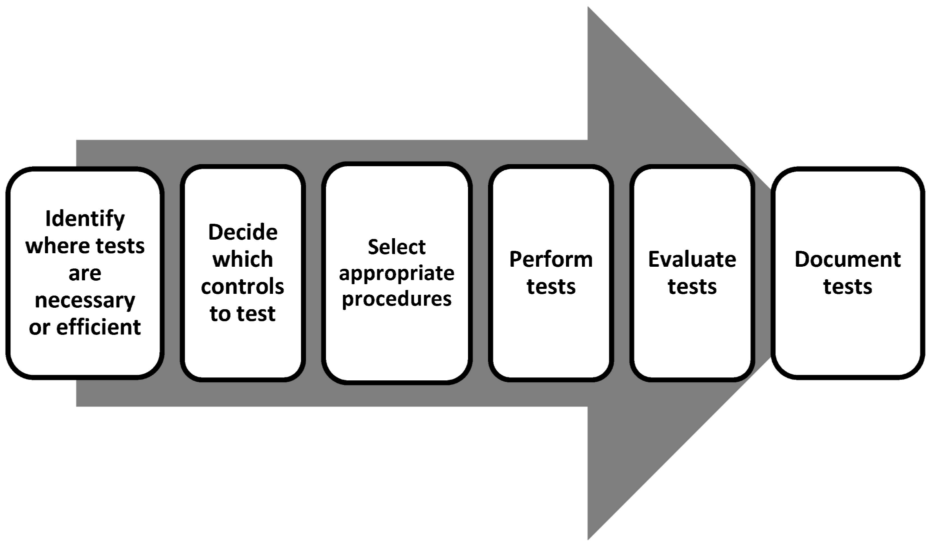
Step 5 Evaluate the results of the tests and, if necessary, revise the initial control risk assessment and the risk of material misstatement.

Step 6 Document the tests of controls.

This approach is illustrated in Exhibit 2-3.

Exhibit 2-3

Basic Approach to Tests of Controls



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These steps may overlap or be performed in a varying order. For example, based on the initial audit strategy, the auditor may decide to test operating effectiveness concurrently with evaluating design and implementation. Auditors often decide which controls to test (Step 2) when considering whether testing will be efficient (Step 1). Also, documentation of the tests of controls (Step 6) might be done as the work progresses. However, the step-by-step approach to tests of controls presents a logical framework for the considerations that are normally required. In the remainder of this lesson, each of those steps is discussed in further depth.

Deciding Whether to Test Controls

AU-C 330.08 indicates that tests of controls should be performed in the following situations:

a. When the auditor's assessed risk of material misstatement at the relevant assertion level includes an expectation that controls are operating effectively. In that case, audit evidence is obtained to support the operating effectiveness of those controls. In other words, the understanding of internal control design and implementation allows the auditor to make an initial assessment that incorporates the auditor's expectations about the operating effectiveness of controls. When the auditor makes a reduced control risk assessment based on that initial assessment, the auditor performs tests of controls to obtain the necessary audit evidence to support that expectation.

b. When substantive procedures alone cannot provide sufficient appropriate evidence at the relevant assertion level (that is, when substantive procedures alone are not effective).

In performing an audit, when the auditor's risk assessment includes an expectation of operating effectiveness, it is generally called an audit strategy that includes reliance on internal control. In other words, the audit strategy planned for a particular audit area is a combination of tests of controls and substantive procedures. Before adopting this audit strategy for a particular audit area, the auditor decides whether to test controls for relevant assertions based on the preliminary assessment of the risk of material misstatement. Those decisions may result in audit responses at the relevant assertion level that consist of substantive procedures alone or a combination of substantive procedures and tests of controls.

The Risk Assessment Includes an Expectation of Operating Effectiveness. The auditor needs to know enough about internal control to assess the risk of material misstatement for relevant assertions for classes of transactions, account balances, and disclosures. *PPC's Guide to Audit Risk Assessment* provides an in-depth discussion of risk assessment procedures and the understanding of internal control. Lesson 1 provides a discussion of assessing and responding to risks. When the auditor's risk assessment for a relevant assertion in an audit area includes an expectation of the operating effectiveness of controls, that is, the planned audit strategy includes reliance on internal control, it means that the auditor has:

- Obtained a sufficient understanding of the specific controls that are likely to prevent, or detect and correct, material misstatements in the relevant assertion.
- Evaluated the design of those controls and is satisfied that they are capable of preventing, or detecting and correcting, a material misstatement in the relevant assertion.
- Determined that the controls exist and are being used.
- Decided to rely on the effective operation of those controls when designing substantive procedures.

In other words, the auditor plans to reduce the control risk assessment, based on the expectation that controls are operating effectively, and design substantive procedures that provide sufficient additional audit evidence to reduce detection risk to an acceptable low level. In order to reduce the control risk assessment, the auditor has to obtain audit evidence supporting his or her expectation that such controls are operating effectively. Therefore, the planned further audit procedures will consist of tests of controls and substantive procedures that in combination provide sufficient audit evidence about the assertion being tested.

An expectation of operating effectiveness typically means that the auditor's planned control risk assessment is less than high. In some cases, the combined risk of material misstatement can be assessed at a moderate or low level even though control risk is assessed as high. That might be the case, for example, when inherent risk is low or moderate. In that case, there is no expectation of operating effectiveness and no tests of controls would be performed. The auditor would design substantive procedures that address the combined assessed level of risk.

There may be instances when the auditor is unable to identify controls in place that would prevent, or detect and correct, material misstatements in specific relevant assertions. Similarly, an entity may have limited documentation of the existence or operation of controls. In such cases, which may occur in smaller entities, testing controls may not be a consideration or may be inefficient. AU-C 330.A19 further states that in rare cases in which the auditor has not identified many control activities or other control components, the absence of controls may make it impossible to obtain sufficient appropriate audit evidence.

Without properly designed and implemented controls, the auditor does not have a basis for an expectation of operating effectiveness. Consequently, reliance on controls is not appropriate, and control risk is normally assessed as high. In that situation, the auditor's substantive procedures alone need to be sufficient to respond to the assessed risk of material misstatement.

The auditor may conclude that controls are appropriately designed and implemented but may nevertheless decide that additional tests of operating effectiveness are not warranted. In that case, the auditor does not include his or her expectation of operating effectiveness when making the risk assessment (that is, the auditor does not reduce the control risk assessment). Among other reasons, this decision might be based on the following:

- Materiality and inherent risk considerations.
- Feasibility of performing tests.
- Audit efficiency considerations.

Materiality and Inherent Risk Considerations. After gaining an understanding of the entity and its environment, including its internal control, the auditor first considers the materiality and inherent risk related to specific audit areas by account balance assertion when determining the appropriate response. A reduction of the extent of substantive procedures might be possible based on materiality considerations and the inherent risk assessment alone. In that case, no further attention to control risk or tests of controls would generally be necessary for those areas or assertions. For example, for classes of transactions or account balances that are not material, the auditor might determine, given the nature of the risks, that only limited procedures, such as preliminary and final analytical procedures, is the appropriate response. Also, if the inherent risk for relevant assertions for an account or class of transactions is low, tests of controls might not be appropriate.

Feasibility of Performing Tests. In deciding whether to test controls, the auditor considers whether the amount and persuasiveness of available evidence would be adequate to support the planned reduced control risk assessment. For example, based on the nature of the control, observation and inquiry may be the only procedures that can be used to determine effective operation. If the auditor determines that the control needs to be tested throughout the year, observing the performance of the control in past periods would not be possible. Because inquiry alone is not sufficient when testing controls, there may be insufficient persuasive evidence available to support a reduced assessment of control risk. Likewise, if the planned test of controls involves inspecting documents, the auditor needs to determine that such documentation is available for the entire period being audited.

Audit Efficiency Considerations. In some cases, the auditor may elect to exclude his or her expectation of operating effectiveness from the relevant risk assessment for efficiency reasons. That may be the case when testing the operating effectiveness of controls would be inefficient and substantive procedures alone are considered effective. AU-C 330.A4 supports electing to exclude testing the operating effectiveness of controls from the relevant risk assessment for efficiency reasons.

When Tests of Controls Are Not Efficient. Excluding the effect of controls from the relevant risk assessment would mean assessing control risk as high regardless of the auditor's expectation that controls are designed, implemented and may be operating effectively. In other words, even in situations in which the auditor has made a preliminary assessment that controls may be operating effectively based on his or her evaluation of the design and implementation of controls that would be capable of preventing, or detecting and correcting, material misstatements, the auditor may ultimately decide to assess control risk as high for purposes of audit efficiency and perform only substantive procedures. In order to make that decision, however, the auditor considers whether substantive procedures alone would be an effective response.

Even if testing the operating effectiveness of controls is deemed to be inefficient, the auditor should still perform sufficient risk assessment procedures to have an appropriate basis for assessing the risk of material misstatement, including making the determination that substantive procedures alone are effective. The assessment is a focused consideration of what could go wrong at the assertion level. If the effect of controls is excluded from the relevant risk assessment, that means the auditor's response in substantive procedures has to be adequate to deal with anything that the inherent risk assessment indicates could go wrong. Also, the risk assessment procedures performed have to be sufficient to obtain the understanding of the entity and its environment, including internal control, to make that decision. In other words, the assessment of the risk of material misstatement at the assertion level cannot be made without the understanding of internal control. However, assuming substantive procedures alone are effective, the auditor is allowed to perform substantive procedures only and not test controls, even when controls are believed to be suitably designed and implemented.

Some auditors have traditionally adopted (or defaulted to) a strategy that focuses primarily on the use of substantive audit procedures, based on a belief that substantive procedures alone are effective and testing controls would never be efficient. However, such an attitude may result in overlooking opportunities for greater audit efficiency and effectiveness. Because the auditor is required to obtain an understanding of internal control, the auditor may identify controls that are capable of preventing, or detecting and correcting, material misstatements for relevant assertions. Even in small entities, effective controls may exist that could affect the nature, timing, or extent of substantive procedures. It is important for auditors to thoughtfully consider the results of their understanding of internal control when making a decision about the feasibility or efficiency of testing controls. Decisions about testing controls are normally made assertion-by-assertion based on the preliminary assessment of control risk. Therefore, efficiency decisions are normally considered at the assertion level rather than at a global level for the entity as a whole. Also, even in situations in which the auditor may initially conclude after performing risk assessment procedures that testing controls would not be efficient for an audit area, subsequent audit evidence might reveal that testing controls would either be more efficient or would be required to adequately address audit risk.

When Tests of Controls Would Be Efficient. The auditing standards do not provide guidance for determining when tests of controls would be efficient. (The AICPA Risk Assessment Audit Guide does, however, provide some considerations that are incorporated into the following discussion.) In practice, tests of controls that involve tests of individual transactions can be efficient in the following circumstances:

- The volume of transactions is relatively high.
- The transactions are recurring and relatively uniform within the transaction class.
- The transactions are not complex.
- The transactions are routinely processed in information systems with well-designed control activities.
- The entity's control environment, monitoring, and risk assessment processes are conducive to effective controls.

In those circumstances, it may be efficient to assess the risk of material misstatement with an expectation of the operating effectiveness of controls, that is, to assess control risk at less than high and test controls. Another circumstance that may lend itself to efficient tests of controls is the situation where key controls for preventing, or detecting and correcting, material misstatements consist primarily of high level monitoring or other entity-level controls that are easy to test.

Deciding Whether Tests of Controls Are Efficient. When considering whether tests of controls would be efficient, the auditor can evaluate the following cost/benefit factors:

- *Effect on Substantive Procedures.* By performing tests of the operating effectiveness of controls, the auditor may be able to alter the nature, timing, or extent of substantive procedures. For example, when the auditor uses sampling in planned substantive procedures, sample sizes will generally be lower when the auditor tests the operating effectiveness of controls. The lower level of assessed risk allows the auditor to reduce the confidence levels required in sampling applications.
- *Relevant Costs.* When determining a preliminary audit strategy, some auditors may mistakenly believe that a decision to not test the operating effectiveness of controls will eliminate some or much of the audit work involved in obtaining an understanding of internal control. The auditor is required to obtain an understanding that includes an evaluation of the design of relevant controls and determination of their implementation. Therefore, the relevant cost in an efficiency decision is only the incremental cost of testing the operating effectiveness of controls.
- *The Need to Test Indirect (or Complementary) Controls.* When considering the cost of testing controls, auditors should not lose sight of the possible need to obtain audit evidence about information that allows the effective operation of those controls. When designing and performing tests of controls, auditors are required to determine whether controls to be tested depend upon other controls and, if so, whether it is necessary to test the operating effectiveness of those indirect controls. For example, if the credit manager makes credit approval decisions on new or subsequent customer orders based on an internally developed credit approval rating system, the auditor should understand, and possibly test, the controls over the rating system in addition to testing the approval process. Furthermore, when testing automated application controls, the auditor needs to consider the effective functioning of general controls.
- *Whether Controls Have Changed During the Audit Period.* During the audit period, an entity may redesign its controls or implement new controls. AU-C 330.A21 indicates use of substantially different controls at different times during the period under audit necessitates consideration of each control. The need to design and perform control tests of controls that changed during the period may have a significant impact on efficiency considerations. For example, the same test may not be effective both before and after the control change and, therefore, two or more different tests may be needed.
- *The Effect on Future Audits.* An auditor may be able to use audit evidence from tests of controls over a three-year period, subject to certain conditions. Therefore, auditors may not want to isolate their

cost-benefit analysis to only the current audit in continuing engagements where controls are not expected to change significantly from year to year. In those cases, the benefits from reduced substantive procedures may be realized for three years if controls can be rotationally tested.

- *Whether Assertions Can Be Tested Using Computer-assisted Audit Techniques.* Some auditors believe that when using computer-assisted audit techniques (CAAT), some account balances or transaction classes can be audited 100% more efficiently than by testing controls in order to reduce the extent of substantive procedures. However, where the information used to perform the substantive procedures is produced by the entity's information system, the auditor needs to obtain evidence about the information's accuracy and completeness. Also, the auditor's use of CAAT does not eliminate the need to have an understanding of the controls over the system, including IT general controls and particularly the portion of the system that generated the copy of the file being tested by CAAT.

- *Client Expectations.* An auditor might test controls for reasons other than audit purposes. For instance, the client may specifically engage the auditor to test controls. Or the client may have expectations that controls will be tested, and the auditor may decide to do so only to meet those expectations as a client service and to provide added value. In such cases, the auditor tests controls even though the auditor would not otherwise have done so.

Tests of Revenues and Expenses. In testing revenue and expense accounts, audit efficiency may be improved by including tests of controls in the mix of further procedures performed to test revenue and expense accounts. The auditor begins the planning of audit work on revenue and expense accounts by assessing the inherent risk of material misstatement as specifically as possible. Then the auditor considers the evidence provided by substantive procedures applied to related balance sheet accounts. The next step is usually to consider the evidence that would be provided by well-designed analytical procedures. In some cases, however, sufficiently effective analytical procedures are not available because reliable relationships with other financial and nonfinancial information do not exist. Some expense accounts, for example, are difficult to predict.

In these circumstances, the auditor considers whether a combination of evidence from substantive analytical procedures and tests of controls may be sufficient to reduce the risks of material misstatement before performing tests of details of a selection on individual expense transactions. For example, because all expenditure disbursements are normally subject to the same controls, a combination of substantive analytical procedures and tests of controls may be a more efficient source of evidence than tests of details of individual transactions for each expense category.

Substantive Procedures Alone Do Not Provide Sufficient Audit Evidence. As discussed in Lesson 1, AU-C 315.31 notes that auditors are required to obtain an understanding of controls related to risks for which it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures. AU-C 330.08 requires the auditor to test the relevant controls for operating effectiveness. Thus, auditors should identify risks for which substantive procedures alone are not effective. Those risks often occur in audit areas in which there is highly automated processing with little or no manual intervention. Due to the importance of effective controls over accuracy and completeness in that processing environment, it may not be practical, or even possible, to perform only substantive procedures and not test controls.

Examples of When Testing Controls May Be Necessary. The auditor may decide that it is necessary to test controls when an entity's accounting data and corroborating evidence are available only in electronic form (for example, when a significant amount of information supporting one or more financial statement assertions is electronically initiated, authorized, recorded, processed, or reported and related audit evidence exists only in electronic form). In those instances, the risk of improperly initiating or altering information without detection is greater if appropriate controls are not operating effectively. Also, the appropriateness and sufficiency of the audit evidence usually depend on having effective controls over the accuracy and completeness of processing. For example, it may be necessary to perform tests of controls when an entity uses the computer to initiate orders for goods based on predetermined rules, and pays the related payables based on electronic information in transactions concerning receipt of goods, and no other documentation of orders or receipts is produced or maintained.

Some auditors believe that when the risk of theft of cash is significant, it is usually necessary to test controls over cash receipts and disbursements. For example, with respect to revenues received primarily in cash (such as those of some fast food restaurants or charitable organizations), it may be difficult to limit audit risk for the completeness assertion to an appropriate level without an assessed level of control risk at less than high. If auditors believe that there is a significant risk of error or theft of cash through cash disbursements, they may first test high-level controls, such as the reconciliation routine, segregation of duties, and management oversight of the process. If the effectiveness of high-level controls is not sufficient to allow assessing control risk as low, the auditor may then also test a selection of disbursements for controls designed to prevent or detect theft (such as evidence of an invoice and evidence of proper authorizations), as well as for proper account coding. If the tests of transactions show the controls to be operating effectively, the auditor may be able to assess control risk at less than high and reduce the extent of vouching in other audit areas. For example, an auditor might assess control risk for occurrence and classification of expenses at less than high based on an adequate control environment and tests showing effective controls over disbursements.

Another circumstance in which tests of controls may be required arises when the entity uses a service organization. The service organization may provide services that are relevant to the audit because the services are part of the user entity's (audited company's) information system relevant to financial reporting as described in AU-C 402, *Audit Considerations Related to an Entity Using a Service Organization,* at AU-C 402.03. When the services are not limited to processing a user entity's transactions that were specifically authorized by the entity, then AU-C 402 applies. If the user auditor's audit strategy includes an expectation that controls at the service organization are operating effectively, then the user auditor is required to obtain evidence about the operating effectiveness of those controls.

AU-C 402.A27 observes that when the service organization maintains material elements of the accounting records of the user entity, then the user auditor may conclude that access to those records may be necessary for the user auditor to obtain sufficient appropriate audit evidence relating to the operations of controls over those records. For example, when a service organization initiates transactions as an investment advisor, has custodial responsibility for securities, and services those securities, all of the information available to the auditor is based on the service organization's information. In these circumstances, the auditor may not be able to limit audit risk in designing substantive procedures without obtaining audit evidence about the operating effectiveness of key controls of the service organization. In other words, the auditor will not be able to rely on substantive procedures performed at the user entity alone.

Deciding Which Controls to Test

The most efficient and effective approach to deciding which controls to test is to take a top-down approach. Begin with the financial statements and identify the significant classes of transactions, account balances, and disclosures. Then, identify the significant transaction classes and processes that result in those account balances and disclosures. Within those transaction classes and processes, identify the controls that individually or in combination with other controls prevent, or detect and correct, material misstatements in the relevant assertions related to identified risks. This approach normally results in emphasizing the areas in which material misstatements are most likely to occur.

It is also efficient and effective to consider company-wide or entity-level controls before testing control activities. One reason to take this approach is that if the controls at the top level are poor, it creates an environment that is not conducive to effective controls, and even well-designed and implemented control activities might not be effective. In that case, testing control activities may not be productive. Another reason is that some controls at the top might operate at a direct and detailed enough level to reduce the risk of material misstatement at the relevant assertion level. If that is the case, it might be easier and more efficient to test the entity-level controls than control activities, or testing those controls might at least permit a reduction in the extent of testing control activities.

The following paragraphs discuss various aspects of deciding which controls to test, including:

- Test only those controls that are suitably designed and implemented.
- Test controls within significant processes, but do not test process steps independently of controls.
- Test controls relevant to the risks of material misstatement of relevant assertions.
- Test the key controls that are relevant to the identified risks.

- Consider the need to test indirect or complimentary controls that support the effective operation of control activities being tested.

- If several controls yield equivalent evidence, test the easy-to-test controls.

Only Suitably Designed and Implemented Controls. AU-C 330.A21 emphasizes that only those controls that the auditor has determined are suitably designed to prevent or detect and correct a material misstatement in a relevant assertion need to be tested for operating effectiveness.

There is no benefit to testing the operating effectiveness of a control that is inappropriately designed to prevent, or detect and correct, a material misstatement in a relevant assertion. Even if an improperly designed control could be found to be consistently applied and operating as designed throughout the year, no amount of testing will transform it into a control that is capable of preventing, or detecting and correcting, misstatements.

Also, there is no benefit in testing a control that has not been properly implemented. For example, an auditor might conclude that the documentation of controls in the client's accounting procedures manual indicates that controls are effectively designed to address risks of material misstatement and satisfy relevant principles or control objectives. However, when determining whether the controls are implemented by performing various risk assessment procedures, the auditor finds that the controls, as designed, are not properly communicated or followed. In that case, tests of those controls would not be performed.

Tests of Controls versus Processes. When designing and performing tests of controls, it is important for auditors to ensure that the item being tested is, in fact, a control and not a processing step. A process is best described by example. A *process* would be the coding of an invoice by the accounts payable clerk and the subsequent input to the payable system. A *control*, however, addresses the risk of what could go wrong in the process, and by doing so it either prevents, or detects and corrects, misstatements that could occur as a result of processing the transaction. In the accounts payable area, examples of controls include supervisory review of the amounts input and account coding, the use of programmed restrictions in the accounts payable system that limit which accounts are eligible for coding, or programmed edit routines that detect input amounts that do not agree to underlying purchase orders. While this concern is more appropriately addressed when evaluating the design and implementation of controls, the authors believe that auditors should take care that their control tests do not incorporate a process without a corresponding control.

Controls Relevant to Identified Risks. Control testing is focused on those controls that are relevant to risks the auditor has identified (that is, the risk that the assertion is misstated). The auditor does not always have to test all the control activities relating to an assertion to assess control risk at less than high. Often, the control activities component of internal control is the one most directly related to specific assertions, and the auditor will test control activities. However, as discussed earlier in this lesson, entity-level controls may operate at a direct and detailed-enough level to reduce the risk of material misstatement for a specific relevant assertion, and the auditor may consider testing entity-level controls. For fraud risks or other significant risks, as well as risks for which substantive procedures alone are not adequate, the auditor should obtain an understanding of the design and implementation of the related controls, which can serve as a basis for determining which controls to test.

Key Controls. The auditor normally focuses on those controls that are most important in preventing, or detecting and correcting, material misstatements in the relevant assertions, i.e., key controls. Those key controls often include actions of supervisors and senior management and may include documentation of supervision, budgeting, reporting, review, etc., that can be easily tested by inquiry, observation, and inspection of reports and documents. Not only is it easier and more efficient to test such controls (such as by reviewing the client's investigation and variance reports) than it is to perform detailed tests of transactions, but the tests may also provide more assurance about the controls than tests of transactions. For example, management may prepare budgets, periodically compare them to actual results, and investigate significant variations in a timely manner, or management may compare financial statement results to relevant operational data, such as comparing units or hours billed to units shipped or hours charged. Reports of the variations, investigative actions, explanations of the variations resulting from the investigations, and corrective actions taken may provide evidence of the effective operation of the control. Such a control may be a key one with respect to relevant assertions for revenues or expenses.

Indirect or Complementary Controls. AU-C 330.10 indicates that when designing and performing tests of controls, the auditor should determine whether the controls to be tested depend upon other controls (indirect controls) and, if so, whether obtaining audit evidence about the operating effectiveness of those indirect controls is necessary. The AICPA Risk Assessment Audit Guide refers to these indirect controls as complementary controls. For example, if the auditor decides to test the operating effectiveness of a user review of an exception report of sales in excess of authorized credit limits, the auditor also considers whether it is necessary to test the operating effectiveness of controls over the accuracy of information in the report, such as IT general controls.

Indirect or complementary controls may include:

- Controls over the accuracy and completeness of information used in the performance of the direct control.
- IT general controls.
- Segregation of duties.
- The control environment.

Determining whether to test indirect or complementary controls and the nature and extent of those tests requires judgment. Some of the factors that might be considered when making such decisions are:

- *Significance of the Indirect or Complementary Control to the Effective Functioning of the Direct Control.* The significance of an indirect control to the effective functioning of the related direct control may vary greatly depending on the situation. Obviously, as the degree of significance increases, the need for audit evidence about the indirect control also increases. In some situations, such as for IT application and general controls, the conclusion reached on the operating effectiveness of the direct (application) control may be based primarily on the audit evidence related to the indirect (general) control.
- *Degree of Assurance Required from Tests of Operating Effectiveness.* If the auditor requires a greater degree of reliability or assurance from the tests of operating effectiveness, the degree of audit evidence needed about indirect controls also normally increases.
- *Evidence Obtained through Risk Assessment Procedures.* When the auditor performs risk assessment procedures to understand the direct control, evidence about the operating effectiveness of complementary controls might also be obtained. In certain situations, the auditor might possibly determine that sufficient evidence about the complementary controls has been obtained from risk assessment procedures alone after considering the factors previously discussed.

When evaluating whether to test controls from an efficiency perspective, the auditor normally considers the additional costs of testing indirect controls to determine if testing is cost effective. For example, the auditor determines that the client's cash reconciliation is a key control that, if operating effectively, will allow a modification in the nature of substantive procedures for cash. The reconciliation, research, and resolution of identified issues is the key control, but the effective operation of the control is also dependent on proper segregation of duties. If the reconciliation was performed by individuals that have the ability to post cash receipts and disbursement activity to the general ledger, the effectiveness of the control may be compromised. Therefore, as part of testing the operation of the control, the auditor also would want to ensure that proper segregation of duties was maintained for individuals performing the control.

Easy-to-test Controls. Some controls may be easier to test than other controls and yet yield equivalent persuasive evidence to support a risk assessment. Naturally, if there is a choice, the auditor would normally test the control that is easier to test, considering the availability and persuasiveness of audit evidence. The auditor would not, however, test controls that are not relevant to the audit just because the controls are easy to test.

Selecting Appropriate Procedures

Tests of controls are further audit procedures that are performed with the objective of obtaining audit evidence about the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level. AU-C 330.09 notes that, when designing and performing tests of controls, the auditor is required to obtain more persuasive audit evidence as the degree of reliance on the effectiveness of a control increases.

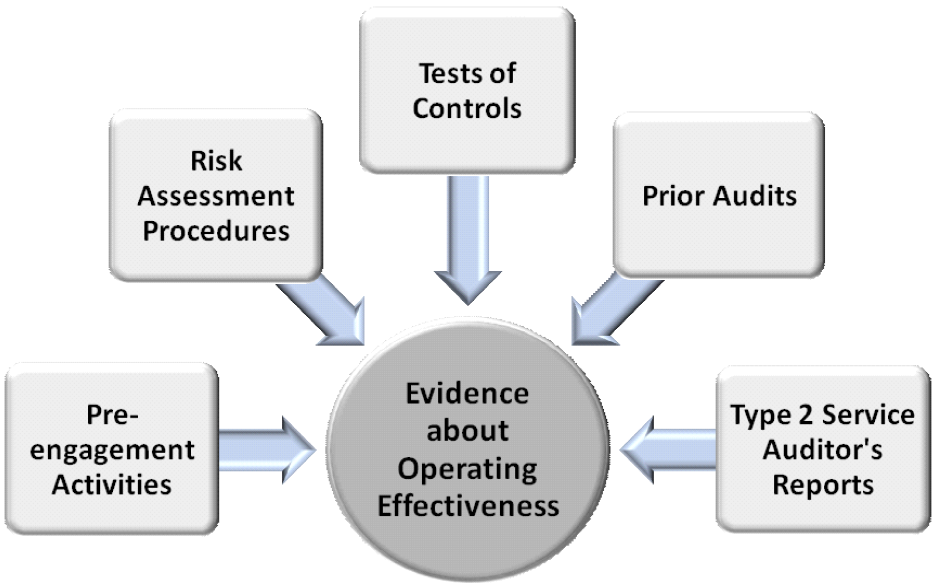
Auditors may perform one or a combination of tests to obtain the level of assurance needed to support the assessed level of control risk. When selecting control tests, auditors consider the cumulative evidence about operating effectiveness that is obtained from various sources.

This section discusses the nature and types of tests of controls. The time frame for testing controls, the extent of such tests, efficiency opportunities when testing controls, and other matters related to performing tests of controls, as well as tests of IT related controls, are discussed later in this lesson.

Evidence about the operating effectiveness of controls is generally obtained through tests of controls, but such evidence may also be derived from a variety of sources as noted in Exhibit 2-4:

Exhibit 2-4

Sources of Evidence about Operating Effectiveness of Controls



* * *

The sources of evidence about operating effectiveness other than direct tests of controls are further explained as follows:

- *Pre-engagement Activities.* Procedures and conclusions reached regarding client acceptance or continuance may provide evidence regarding management's ethical values, operating philosophy, integrity, and competence.
- *The Understanding of Controls Obtained as Part of the Risk Assessment Process.* Many of the procedures commonly used in the risk assessment process to gain an understanding of internal control also may provide evidence about the controls' operating effectiveness.
- *Prior Audits.* AU-C 330 explicitly recognizes that the auditor may be able to use audit evidence about the operating effectiveness of controls obtained in previous audits.
- *Type 2 Service Auditor's Report.* A service auditor may apply tests of controls at a service organization and report on whether the controls are operating effectively to achieve principles or specified control objectives. This type of report, also known as a "Type 2 report," may be helpful in determining whether controls have been suitability designed and implemented, and in assessing control risk at either a low or moderate level when relevant controls are applied at the service organization.

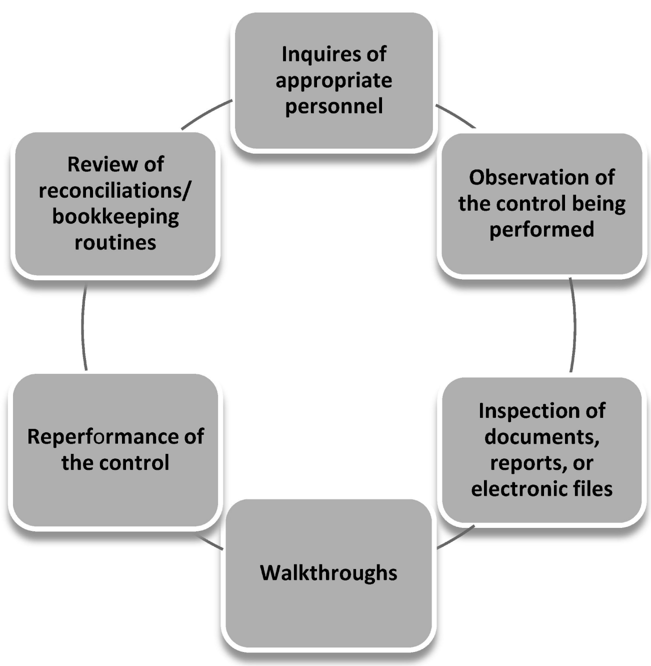
Substantive procedures may provide additional evidence that is consistent with the auditor's conclusion about the operating effectiveness of controls or that creates the need to reevaluate the prior assessment of control risk. AU-C 330.16 notes that auditors should evaluate whether misstatements that have been detected by substantive procedures indicate that controls are not operating effectively. According to AU-C 330.A43, the identification of a material misstatement in the financial statements that would not have been detected by the entity's internal controls is an indicator of a material weakness. However, auditors should be aware that a lack of misstatements as a result of substantive procedures does not provide audit evidence about the operating effectiveness of controls. The auditor's responsibility for reporting internal control matters, including significant deficiencies and material weaknesses, is discussed later in this lesson.

Understanding the potential sources of evidence is important to the auditor when designing tests of controls, considering the extent and timing of those tests, and evaluating the effect on the control risk assessment. The audit evidence provided from various sources is normally considered in a cumulative manner when deciding whether sufficient applicable evidence has been obtained to support the auditor's evaluation of operating effectiveness and the final assessment of control risk. In choosing procedures to test a control, consider the degree of assurance provided by the procedure in relation to the degree needed. If there is a choice, choose the procedure that is most efficient in providing the needed degree of assurance.

Nature and Types of Tests of Controls. Tests of controls (either manual or automated) ordinarily include procedures such as those shown in Exhibit 2-5:

Exhibit 2-5

Test of Controls Procedures



* * *

The information and evidence typically sought from tests of controls include the following:

- What the control is.
- Who performs it, including the person's name and job title, and whether the person has the necessary authority and competence.
- How it was performed at relevant times during the period.

- The consistency with which it was performed during the period.
- What reports, files, or other documents are used in performing the control.
- What reports, files, or other documents, if any, are produced as evidence of the performance of the control.
- What action is taken if the control reveals an error, discrepancy, or unusual item.
- How supervisory and managerial personnel satisfy themselves that the control is operating as planned to prevent or detect errors.

The auditor often obtains evidence about the operating effectiveness of controls by performing a combination of the procedures listed in Exhibit 2-5, as well as from the understanding of controls and prior audits. The procedures and sources of information complement and supplement one another. For example, an auditor may inquire about the existence and nature of a control activity, have the person who performs it demonstrate or walk through the steps involved, and inspect the documents or electronic files used or reports produced. In this example, the auditor would have used inquiry, observation, inspection, and a walkthrough. These procedures would not only provide the auditor with an understanding of the control activity, but would also constitute a test of the control. Walkthroughs in a test of controls are discussed further later in this lesson.

According to AU-C 330, inquiry alone is not sufficient to obtain reasonable assurance of operating effectiveness. Thus, the auditor should perform other procedures in combination with inquiry. AU-C 330.A28 indicates that when inquiry is combined with inspection, recalculation, or reperformance there is more assurance than that provided by only inquiry and observation because an observation is pertinent only when it is made. For example, the auditor might inquire about and observe the procedures for opening mail and processing cash receipts. To obtain greater assurance, the auditor could supplement those inquiries and observations with procedures such as inspecting documents (for example, prelists of cash receipts) and, possibly, reperformance procedures (for example, reperforming the comparison of amounts on prelists to accounting records and bank deposits).

AU-C 330.A29 explains that the nature of the control being tested will generally direct the type of procedure necessary to obtain audit evidence about operating effectiveness. For example, a control in which a manager reviews the clerical accuracy of the coding of invoices over $1,000 may be evidenced by the manager's initials on the invoice. The nature of this control would generally dictate the auditor's procedures to be inspection of the invoice for documentation of the manager's initials combined with reperformance of the control activity (that is, a check of the clerical accuracy).

For some controls, however, documentation may not be relevant or available. For example, the operation of certain aspects of the control environment, such as the assignment of authority and responsibility, might not be documented. Similarly, the operation of certain control activities, such as those performed by the computer, might not be documented. In those cases, the auditor may need to perform inquiry in combination with other procedures, such as observation or the use of CAAT, to obtain audit evidence about operating effectiveness. Reperformance alone, inquiry, or observation of the control being performed would generally not provide the quality of audit evidence normally required by the auditor.

Efficiency is also a consideration when selecting audit procedures. If there is a choice, choose the procedure that is most efficient in providing the needed degree of assurance. The following paragraphs discuss the procedures commonly used to test controls.

Inquiry and Observation. Inquiry and observation are often used in the general planning and risk assessment phase of the audit to obtain an understanding of controls and whether they have been implemented. While making inquiries and observations for that purpose, the auditor may also gain evidence about the controls' operating effectiveness. Inquiry and observation are typically used to test controls that do not produce documentary evidence of performance, such as separation of duties, controls over access to assets and records, certain entity-level controls, or some control activities performed by a computer. Inquiry and observation often complement or supplement each other. For example, the auditor might inquire about the existence of a particular control activity and then observe the activity being performed to determine that it is in fact in operation and perhaps also to assess its effectiveness. Similarly, observation would normally be supplemented by inquiry, since observation is only pertinent at the point in time at which it is made. Additional considerations about observation as a source of evidence about controls are discussed later in this lesson.

The auditor may be able to document inquiries and observations in a form, such as the one provided in *PPC's Guide to Audit Risk Assessment.* Another option is to document the inquiries and observations in a memo that identifies the purpose of the inquiries and observations, the types of transactions covered by the control, the date of the inquiry or observation, the person(s) interviewed or observed and their position(s), the questions asked and the replies received, or activities observed.

Inspection of Documents, Reports, or Electronic Files. This procedure includes inspection of source documents (such as invoices, bills of lading, and receiving reports), log books (such as shipping and receiving logs), reports (such as internal auditors' reports and exception reports), accounting procedures manuals, or (for operating effectiveness) electronic files. Documents are inspected for an indication that the control activity was performed (for example, initials of the person who approved a transaction or a clerk's checkmark indicating that a total was footed or an extension checked). Reports, which may include internally produced financial or operational reports or externally produced reports of financial institutions, regulatory agencies, service organization auditors, etc., are reviewed for a description of the activity or investigation performed, the resulting findings, and the client's response to problems detected.

Audit sampling is sometimes used in tests of controls that involve inspection of documents. However, tests of controls involving document inspection do not necessarily require sampling, for example, inspection of documents in conjunction with inquiries and observations, walkthroughs, or reviews of reconciliations. Sampling in tests of controls is discussed further later in this lesson.

Walkthroughs. Walkthroughs are commonly used in gaining an understanding (or further understanding) of controls. A walkthrough can also serve as a test of controls and in some cases, along with other tests of controls (such as inquiry, observation, document inspection, and reperformance), can provide a valid basis for assessing control risk at less than high. However, this approach generally by itself does not provide a sufficient basis for assessing control risk as low. As explained in paragraphs 6.65–.66 of the AICPA Risk Assessment Audit Guide, the auditor may consider whether the walkthrough and other procedures performed are adequate to provide evidence about the operating effectiveness of the control. The adequacy would depend on the nature of the control (for example, automated versus manual) and the nature of the procedures performed (for example, inquiry about the entire year and observation versus examination of documents or reperformance). The walkthrough may provide evidence to reduce but not eliminate other control testing, and it may be necessary to test other instances of the operation of the control to reach a conclusion about operating effectiveness.

Review of Reconciliations and Similar Bookkeeping Routines. Reviews of reconciliations and similar bookkeeping routines can be very efficient tests of controls. They may include review of the following:

- Accounting for the numerical sequence of documents.
- Follow-up of unmatched items.
- Reconciliation of a subsidiary ledger to the control account.
- Reconciliation of third-party information to the accounting records (for example, bank reconciliation or vendor statement).
- Reconciliation of related nonaccounting data (for example, units shipped to units billed).

As previously discussed, it is important to ensure, however, that a control rather than just a process is being tested.

The auditor's approach to testing these routines is generally as follows:

- Inspect evidence that the routine was performed throughout the period (for example, reports of unmatched items or written bank reconciliations).

- Inspect examples of the routine having been performed.
- Investigate the resolution of significant misstatements or exceptions disclosed by the routine, or investigate a few if none are significant.

In this approach, the auditor's objective is to confirm that the routine is being performed throughout the period and that misstatements and exceptions are being appropriately investigated and resolved. Thus, this approach does not involve audit sampling, even though there is documentary evidence of performance of the routines.

Reperformance of the Control Activity. Examples of reperformance tests of controls include recomputing extensions and totals on sales invoices, tracing units billed from an invoice to a shipping document, or recomputing gross pay. Reperformance tests are commonly performed along with inspection of documents. For example, the auditor may test the clerical accuracy of a sales invoice and inspect supporting documents for evidence of proper approval. Audit sampling is sometimes used in tests of controls that involve reperformance of control activities applied to documented transactions. Sampling in tests of controls is discussed later in this lesson.

An advantage of reperformance is that it usually provides substantive audit evidence about the transaction as well as about the control activity (that is, it is a dual-purpose test). For example, the auditor will obtain evidence that the transaction is recorded in the proper account at the proper amount as well as that it was properly approved.

Reperformance tests can be very time-consuming. Thus, the auditor may better served to avoid unnecessary reperformance tests. However, such tests may be necessary (instead of or in addition to other tests such as inquiry or observation) if the control is particularly significant or if controls are tested when the control environment is not strong.

Performing Tests of Controls

As noted earlier in this lesson, testing controls includes obtaining evidence about:

- How controls were applied at relevant times during the audit period.
- The consistency of application.
- Who applied the controls and the means of their application, including whether the person performing them had the necessary authority and competence.

The objective of performing tests of controls is to obtain sufficient appropriate audit evidence about their operating effectiveness to support the auditor's assessment of control risk.

The following paragraphs discuss the timing of tests of controls, the extent of such tests, efficiency opportunities when testing controls, tests of IT related controls, and other matters related to performing tests of controls.

Timing of Tests of Controls. AU-C 330.11 indicates that the auditor should test controls for the particular time or throughout the period of intended reliance. The appropriate timing depends upon the auditor's objective and for what period of time reliance is needed about the operating effectiveness of controls. When a control is tested at a point in time, the audit evidence can only support a conclusion about operating effectiveness at that point in time. Conversely, when a control is tested over a period of time, the audit evidence can be used to form a conclusion about operating effectiveness over that period.

In some cases, the control being tested need only be tested at a point in time. For example, for controls over the observation of the annual physical inventory, testing would only be relevant at that point in time since the controls are only applied once. Other controls, however, may operate throughout the audit period, requiring the auditor to collect evidence about operating effectiveness for the entire period. For an automated control that operates throughout the period, the auditor might be able to test the operation of the control at a point in time and collect evidence about its continued operation through tests of general controls.

Other considerations related to the timing of control tests include the following:

- Whether to perform the tests at an interim date or at period end.

- Whether to use audit evidence about the operating effectiveness of controls obtained in prior audits.

Interim Testing of Controls. Based on the audit strategy, the auditor might decide to perform tests of controls through an interim date prior to the balance sheet date. AU-C 330.12 requires the following when auditors perform tests of controls through an interim date:

- Auditors should obtain audit evidence about significant changes in those controls that occur during the remaining period.
- Auditors should determine what additional audit evidence to obtain for the remaining period considering factors such as:
  - Significance of the assessed risks of material misstatement at the relevant assertion level.
  - Specific controls tested during the interim period and the results of the tests.
  - Significant changes to controls since they were tested, including changes in the information system, processes, and personnel.
  - Degree to which audit evidence about operating effectiveness was obtained.
  - Length of the remaining period.
  - Extent to which further substantive procedures will be reduced based on control reliance.
  - Effectiveness of the control environment.

Additional audit evidence about the operating effectiveness of controls over the remaining period of time can be obtained by extending the tests of controls over the remaining period or testing the entity's monitoring of controls.

Using Audit Evidence Obtained in Previous Audits. AU-C 330 explicitly recognizes that the auditor may be able to use audit evidence about the operating effectiveness of controls obtained in prior audits subject to certain defined restrictions. If these restrictions are met, the audit practice of rotating tests of controls over a three year cycle might be used. AU-C 330.13–.15 explains the following guidelines for rotating tests of controls:

- When the auditor plans to use evidence from a previous audit about the operating effectiveness of controls, the auditor should perform procedures to determine whether the information obtained previously continues to be relevant for the current audit. In other words, the auditor determines if changes have occurred since the previous audit, such as changes in the system, personnel performing the controls, or the control environment, that affect the relevance of previous audit evidence.
- The evidence about whether changes have occurred should be obtained by performing inquiry combined with observation or inspection to confirm the understanding of those specific controls. Inquiry alone is not enough.
- If there have been changes that affect the continuing relevance of the audit evidence obtained in a previous audit, the controls should be tested in the current audit. Rotation of testing is not appropriate if there have been changes.
- If there have not been changes, the auditor should test the controls at least once in every third year in an annual audit.
- If a number of controls are rotationally tested, the auditor should perform some tests of controls each year. It is not acceptable to test all controls in a single audit period with no testing in the subsequent two audit periods.
- Rotation of testing is not permitted if the auditor plans to rely on controls that mitigate a fraud risk or other significant risk. For controls related to significant risks, the tests of controls should be performed in the current period.

- In considering whether rotation is appropriate and the time elapsed before retesting, the auditor should consider the factors in Exhibit 2-6.

Exhibit 2-6

Factors to Consider Regarding Rotation of Control Tests

Factor	Examples	Impact on Decision to Rotate Control Tests	Impact on Time Elapsed Before Retesting
Effectiveness of other elements of internal control, including the entity's control environment, monitoring, and risk assessment process.	• Design effectiveness and implementation of monitoring over relevant controls has improved. • Deterioration in the design effectiveness and implementation of control environment or monitoring elements.	• Rotation would generally be appropriate. • Question the appropriateness of rotating tests.	• Consider retesting every third year. • Consider shortening the time elapsed before retesting.
Whether the control is manual or automated.	• Control is automated and general IT controls are effective. • A manual control requires intricate steps and judgment on the part of the individual who performs it.	• Rotation would generally be appropriate. • Question the appropriateness of rotating tests.	• Consider retesting every third year. • Consider retesting each year.
Effectiveness of IT general controls.	• IT general controls are not designed or operating effectively.	• Depending on the significance of the general controls to the application control, rotation would generally not be appropriate.	• Consider retesting pertinent application controls each year (or consider the appropriateness of testing).
How the control is applied, including the nature and extent of deviations detected in prior audits and whether any personnel changes have occurred that significantly affect the control's application.	• Testing of control in prior audits did not reveal any deviations. • Testing of control in prior year revealed one or more unresolved deviations. • New personnel in the current year with less experience and background who apply the control.	• Rotation would generally be appropriate. • Question the appropriateness of rotating tests, depending on the nature of the deviation. • Question the appropriateness of rotating tests.	• Consider retesting every third year. • Consider retesting each year, depending on the nature of the deviation. • Consider retesting in the current year.

Factor	Examples	Impact on Decision to Rotate Control Tests	Impact on Time Elapsed Before Retesting
Whether the control should have changed in response to changing circumstances but did not.	• Control remains unchanged from prior audits, but the changed circumstance does not impact the nature of the risk the control is addressing.	• Rotation would generally be appropriate.	• Consider retesting every third year contingent upon the status of the changed circumstances.
	• Control remains unchanged from prior audits, and the changed circumstance directly impacts the risk the control is addressing.	• Consider whether control remains appropriately designed prior to rotating control tests.	• If the control remains appropriately designed, consider the status of the changed circumstances when deciding how often to retest.
Risks of material misstatement and the extent of reliance on the control.	• Control risk is preliminarily assessed at moderate and planned substantive procedures will not be substantially modified.	• Rotation would generally be appropriate.	• Consider retesting every third year.
	• Control risk is preliminarily assessed at low and planned substantive procedures will be extensively modified based on the planned reliance on the operating effectiveness.	• Question the appropriateness of rotating tests.	• Consider retesting each year or every other year.

* * *

Rotation of tests of controls on a cyclical basis over three years is, thus, permitted, but the auditor has to obtain persuasive evidence that the controls have not changed in the current period and evaluate the appropriateness of relying on prior tests in the particular circumstances of the current period's audit. That includes considering whether controls should have changed in response to changing circumstances but did not. In other words, the auditor is still obligated to evaluate design effectiveness and determine whether the controls have been implemented each year.

Generally, the higher the auditor's risk assessment or the greater the planned reliance on controls, the shorter the time period between testing controls. Factors that may decrease the time between retesting or cause the auditor to reconsider the appropriateness of rotating tests of controls include the following:

- Deficiencies in the control environment.
- Deficiencies in the entity's monitoring process.
- Deficiencies in IT general controls.

- Significant manual intervention involved in the application of controls.
- Personnel changes.
- Changing circumstances that indicate the need for changes in controls.

Extent of Tests of Controls. AU-C 330.09 indicates that when the auditor designs and performs tests of controls, he or she should obtain more persuasive audit evidence as the reliance the auditor places on the effectiveness of a control increases.

AU-C 330.A31 further explains that in addition to the degree of reliance on controls, factors that may be considered by the auditor when determining the extent of tests of controls include:

- Frequency of the operation of the control.
- Length of time during the audit period that reliance on operating effectiveness is required.
- Extent of tests of other controls (including entity-level controls) that are related to the relevant assertion.
- Relevance and reliability of the audit evidence about operating effectiveness of the control at the relevant assertion level.
- Expected deviation rate of the operation of the control.

AU-C 330.25 indicates that when the auditor designs tests of controls, he or she should determine the means of selecting items for testing that are effective in meeting the purpose of the audit procedure. The auditor has the option of selecting all items in a population, selecting specific items, or audit sampling. Of those methods, audit sampling is generally the most appropriate means of selecting items for tests of controls.

Tests of Controls Not Using Audit Sampling. Procedures performed only to obtain an understanding of internal control (such as a walkthrough) do not involve sampling. Also, sampling ordinarily does not apply to the following types of tests of controls:

- Tests of automated application controls when effective IT general controls are present.
- Analyses of controls for determining the appropriate segregation of duties or other analyses that do not examine documentary evidence of performance.
- Analyses of the effectiveness of security and access controls.
- Tests of high-level controls, for example management oversight, such as management's review of financial statements or specific accounts, that is, product margins or receivables aging, etc.
- Tests directed toward obtaining audit evidence about the operation of the control environment, for example, inquiry or observation of the explanation of variances from budgets when the auditor does not plan to estimate the rate of deviation from the prescribed control.
- Examining actions of directors for assessing their effectiveness, for example, evaluating whether the audit committee is appropriately involved in the financial reporting process.

Test of Controls Using Audit Sampling. Generally, the auditor considers using audit sampling for tests of controls in the following circumstances:

- The control is applied on a transaction basis, for example, matching approved purchase orders to supplier invoices.
- The control operates frequently.

In these circumstances, the auditor can select a sample of transactions, inspect documents, and reperform the related control activities to see whether compliance with the control procedures is acceptable. *PPC's Guide to Audits of Nonpublic Companies* provides additional guidance on sampling in tests of controls.

Concurrent Test of Controls and Substantive Procedure. AU-C 330.A24 explains that the auditor may perform a test of controls concurrently with a test of details on the same transaction. Such a dual purpose test has two objectives—to obtain evidence about the control's operating effectiveness and to detect material misstatements in the account balance or transaction class. For example, while inspecting an invoice and recalculating amounts as a substantive procedure to detect material misstatements, the auditor might also determine from notations on the invoice that client personnel performed control activities such as checking the mathematical accuracy, approval, etc. Each purpose of the test is considered separately when designing the procedures and evaluating the results.

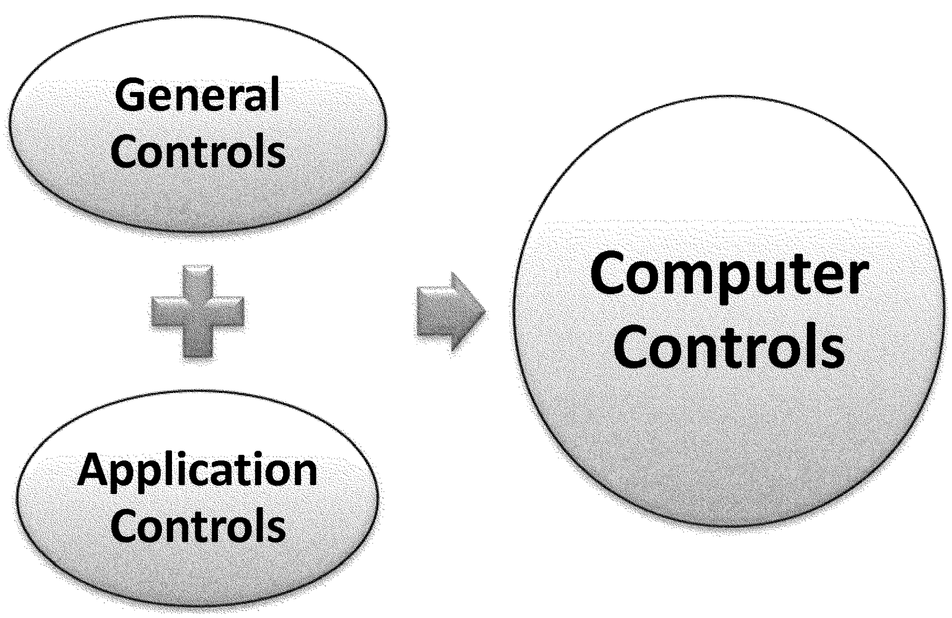
As noted earlier in this lesson, AU-C 330.16 makes it clear that if misstatements are not detected while performing substantive procedures, the lack of misstatements does *not* provide audit evidence about the effectiveness of related controls relevant to the assertions being tested. However, detection of a misstatement by a substantive procedure should be considered in assessing the operating effectiveness of controls. In other words, the auditor should not assume that controls are effective just because a substantive procedure does not detect a misstatement. That means it is not appropriate to consider a substantive procedure as a dual purpose test merely because no misstatements are detected.

Testing IT Related Controls. The auditor's approach to testing IT controls is not fundamentally different than testing other controls. The auditor's primary consideration is whether and how a specific control, individually or in combination with others, prevents, or detects and corrects, material misstatements in classes of transactions, account balances, or disclosures. The auditor focuses on those controls that address areas in which the auditor believes material misstatements are likely to occur.

AU-C 315.22 indicates that the auditor should obtain an understanding of how the entity has responded to risks arising from IT. The guidance further discusses two types of computer controls as illustrated in Exhibit 2-7:

Exhibit 2-7

Types of Computer Control Activities



*   *   *

Application Controls. Application controls apply to the processing of individual transaction applications (such as sales, accounts receivable, and inventory) and relate to the use of IT to initiate, authorize, record, process, and report transactions or other financial data. Application controls help ensure that transactions occurred, are authorized, and are completely and accurately recorded and processed. Examples include edit checks of input data and numerical sequence checks.

Application controls include both programmed controls embedded in the computer program used in the financial reporting system (such as programmed edit controls for verifying customers' account numbers and credit limits) and manual follow-up procedures on computer-produced exception reports. For example, a computerized billing system that produces invoices from shipping data and a master price list might check the numerical sequence of the prenumbered shipping documents and produce a report listing any breaks in the sequence. The follow-up activity would be the investigation of the shipping documents listed in the exception report to find out whether the items were actually shipped and, if they were, why they were not billed, as well as taking any necessary corrective action.

Application controls may be performed by IT, referred to as *automated controls*, or by individuals, referred to as *user controls*.

Because IT processing is inherently consistent, the auditor may be able to limit the testing of automated application controls to one or a few instances of the control application. In that case, the auditor needs to perform tests of controls to determine that (a) the automated control is functioning effectively and (b) the control continues to function effectively. Generally, an automated control will continue to function effectively unless the program or related stored data are changed. Therefore, to reduce the extent of application controls testing, the auditor can perform tests to determine that relevant general controls are operating effectively during the period. When obtaining audit evidence on operating effectiveness of related general controls, tests might include determining that the authorized version of the program is used to process transactions, that unauthorized changes to the program are not made, and that program changes are subject to appropriate program change controls.

General Controls. *General controls* are policies and procedures that relate to many applications. General controls are directed at ensuring the continued proper operation of information systems, thereby supporting the effective functioning of application controls. General controls include the following types of controls:

- Data center and network operations.
- Access security.
- Program change.
- System software acquisition, change, and maintenance.
- Application system acquisition, development, and maintenance.

General controls are important, but unless the auditor pays careful attention to their relation to the risks of material misstatement, the time spent on general controls can be unproductive.

The auditor views general controls in relation to their effect on applications and data that become part of the financial statements. This means that the auditor first focuses on identifying applications that are significant to the financial statements. Then the auditor assesses whether there are general controls that if ineffective would permit application controls to operate improperly and allow misstatements to occur and not to be detected. The auditor can then perform tests of those general controls that are important to the effectiveness of application controls on which the auditor plans to rely.

PPC's Guide to Audits of Nonpublic Companies provides additional guidance on testing IT related controls.

Opportunities for Testing Controls More Efficiently. As discussed earlier in this lesson, audit efficiencies can be achieved by testing controls if the tests and resulting control risk assessment provide a basis for reducing the extent of substantive procedures. Efficiency is gained if the time saved on substantive procedures exceeds the time spent testing controls. Nevertheless, tests of controls, particularly tests involving reperformance and document inspection, can be time consuming. Testing controls is often associated with time-consuming detail testing of documents and transactions, perhaps using sampling. However, testing controls need not necessarily include such detail testing. There are other, more efficient ways of testing controls that may provide sufficient evidence. Also, many auditors erroneously assume that if a transaction is tested, all controls related to the transaction must be tested.

Exhibit 2-8 presents a summary of the opportunities in testing controls more efficiently that are discussed in this lesson. The items in the list are presented in order of importance in achieving efficiency.

Exhibit 2-8

Summary of Efficiency Opportunities in Testing Controls

1. In deciding how much attention to give to controls, first consider the materiality and inherent risk for the audit area. It may be possible to reduce the extent of substantive procedures based on materiality and the assessment of inherent risk even if control risk is assessed as high. Then, no further attention to control risk or tests of controls would be necessary for the area.

2. Do not attempt to assess control risk as low if an assessment as moderate will support the planned extent of substantive procedures. An assessment of control risk as low normally requires obtaining more evidence than will an assessment of moderate.

3. Before testing controls, consider whether the understanding of controls obtained indicates that controls appear to be suitably designed and implemented. Do not test controls that do not appear to be effective.

4. Consider whether procedures performed to obtain an understanding of the design and implementation of controls, such as inquiry, observation, or walkthroughs, can also serve as a test of controls and provide evidence about operating effectiveness. If such procedures are not sufficient to support a reduced assessment of control risk, the auditor should only consider the incremental costs of performing additional testing procedures (compared to the costs already incurred to evaluate design and implementation) when making a decision whether to test the controls from an efficiency perspective.

5. Consider evidence provided by tests of controls performed in previous audits. Consider whether there have been any changes that would affect the relevance of previous audit evidence, and if not, consider performing tests over a three year cycle, as permitted by AU-C 330. Also, when making decisions about the efficiency of testing a control not previously tested in prior years, consider the costs of testing from the perspective of a potential benefit for three engagements, if controls are not expected to change.

6. To save time, consider planning to perform tests of controls at the same time as performing procedures to obtain an understanding of controls or performing a dual-purpose test. AU-C 330.A23 indicates that it may be efficient to test the operating effectiveness of controls at the same time as evaluating their design and obtaining audit evidence of their implementation, and AU-C 330.A24 indicates that the auditor may design a test of controls to be performed concurrently with a test of details of the same transaction. For example, instead of gaining an understanding of controls by having an employee describe a control activity performed and documents used, consider testing it by simultaneously examining the documents and observing the employee performing the activity. Also, AU-C 330.A24 gives the example of examining an invoice to determine whether it has been approved and to obtain substantive evidence of a transaction.

7. Consider whether it is more efficient to test IT general and application controls rather than substantively testing certain computer-produced reports used in the audit. Also, consider reducing the extent of testing of a programmed application control if relevant IT general controls have been tested and found to be effective.

8. Do not test the operation of a process unless the test provides evidence as part of a dual-purpose test. Instead, test only controls that are relevant in preventing, or detecting and correcting, misstatements in the financial statements. Do not test operational or efficiency controls that are not relevant to preventing, or detecting and correcting, misstatements. In addition, do not seek a reduced control risk assessment for all assertions related to an account balance or transaction class. Rather, only test controls related to the assertions or risks of misstatement of the account balance or transaction class that are of concern.

9. Use inquiry, observation, and walkthroughs to the maximum extent possible as tests of controls.

10. Use reviews of reconciliations and similar bookkeeping routines to the extent appropriate. This can be a more efficient, nonsampling test of controls than inspection of documents or reperformance of control procedures.

11. Consider which controls, if effective, would provide a basis for reducing the extent of the planned substantive procedures, then test those controls.

12. In choosing procedures to test a control, consider the degree of assurance provided by the procedures in relation to the degree needed. If there is a choice, choose the procedure that is most efficient in providing the needed degree of assurance.

* * *

Documenting Tests of Controls and the Control Risk Assessment

The following paragraphs explain the documentation requirements for tests of the operating effectiveness of controls. According to AU-C 330.30–.31, the auditor should prepare documentation of the following matters related to testing operating effectiveness:

- *The Nature, Timing, and Extent of Further Audit Procedures.* According to AU-C 500.A10, further audit procedures include tests of controls and substantive procedures. Therefore, the nature, timing, and extent of tests of controls should be documented.

- *The Linkage of Further Audit Procedures (Tests of Controls) With the Assessed Risks (Control Risk Assessment) at the Relevant Assertion Level.*

- *The Results of the Audit Procedures.* Since tests of controls are further audit procedures, the results of tests of controls should be documented.

- *The Conclusions Reached When Not Otherwise Clear.*

- *The Conclusions Reached with Respect to Relying on Audit Evidence About the Operating Effectiveness of Controls Obtained in a Previous Audit.*

AU-C 330.A76 notes that the form and extent of documentation is based on professional judgment and is influenced by the nature, size, and complexity of the entity; its internal control; the availability of information; and the auditor's methodology and use of technology. AU-C 230 provides standards and guidance on documentation.

AU-C 300.09 indicates that the audit plan should include a description of the nature, timing, and extent of planned further audit procedures at the relevant assertion level. Because tests of controls are further audit procedures, planned tests of controls should be documented as part of the detailed audit plan. The detailed audit plan and related documentation requirements were more fully discussed in Lesson 1.

PPC Practice Aids for Documenting Tests of Operating Effectiveness. Auditors can use the practice aids provided in *PPC's Guide to Audit Risk Assessment* to document their tests of controls. Alternatively, auditors can document their tests of controls in a memo.

Memo. If the auditor chooses to use a memo, it should describe the control activity tested, the assertion and audit area to which the control relates; the nature, timing, and extent of the procedures used to test the control's operating effectiveness; and the results of the test. The control risk assessment based on the test would be documented, as would the effect of the assessment on planned substantive procedures.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

12. What is usually the first thing an auditor needs to do when considering whether to perform tests of controls?

    a. Decide which controls need testing.

    b. Identify the areas where the tests are needed.

    c. Select procedures that will be appropriate.

    d. Document the tests that will be performed.

13. Under what circumstances would tests of controls involving tests of individual transactions be the most efficient?

    a. Transaction volume is low.

    b. Transactions are irregular.

    c. Transactions are simple.

    d. Transactions are processed manually.

14. What is an *indirect control*?

    a. An action taken, such as coding an invoice and its input into the payable system.

    b. Something that addresses what can go wrong in a process.

    c. A control that is important to preventing, or detecting and correcting, misstatements in a relevant assertion.

    d. Controls that the controls to be tested depend on.

15. Which of the following is considered a test of controls?

    a. Client acceptance procedures.

    b. Use of a Type 2 service auditor's report.

    c. Walkthroughs.

    d. Further audit procedures.

16. Which of the following statements best describes an aspect of performing tests of controls in an audit engagement?

    a. The objective of performing tests of controls is to eliminate the necessity of performing substantive procedures.

    b. Tests of controls can either be performed as of a point in time or over a specific period of time.

    c. Auditors can use evidence about operating controls from previous audits as long as they rotate it in and out on a five-year cycle.

    d. Tests of controls must be performed independently from tests of details on the same transaction.

17. Which of the following is an efficiency that the auditor can gain when testing controls?

    a. Assess control risk as low instead of moderate when possible.

    b. Limit the use of walkthroughs as much as possible.

    c. Perform tests of controls independently from procedures for obtaining an understanding of controls.

    d. Use reconciliations rather than inspecting documents when possible.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

12. What is usually the first thing an auditor needs to do when considering whether to perform tests of controls? **(Page 70)**

    a. Decide which controls need testing. [This answer is incorrect. This is typically the second step in the basic approach to tests of controls provided by this course.]

    b. Identify the areas where the tests are needed. [This answer is correct. Though the specific steps listed in this course may overlap or be performed in varying order depending on the specific engagement, typically, the first step when considering tests of controls is to identify audit areas where tests of controls are necessary or efficient.]

    c. Select procedures that will be appropriate. [This answer is incorrect. This is typically the third step in the process outlined in this course.]

    d. Document the tests that will be performed. [This answer is incorrect. According to the approach described in this course, typically documentation of tests of controls is the final step in the process.]

13. Under what circumstances would tests of controls involving tests of individual transactions be the most efficient? **(Page 74)**

    a. Transaction volume is low. [This answer is incorrect. Such tests would be more efficient if the volume of transactions is relatively high.]

    b. Transactions are irregular. [This answer is incorrect. Such tests would be more efficient if the transactions are recurring and relatively uniform within the transaction class.]

    c. Transactions are simple. [This answer is correct. Such tests would be more efficient if the transactions are not complex. Therefore, in practice, it would be appropriate for the auditor to perform tests of controls involving test of individual transactions under these circumstances.]

    d. Transactions are processed manually. [This answer is incorrect. Such tests would be more efficient if the transactions are routinely processed in information systems with well-designed control activities.]

14. What is an *indirect control*? **(Page 78)**

    a. An action taken, such as coding an invoice and its input into the payable system. [This answer is incorrect. This describes a *process,* not an indirect control.]

    b. Something that addresses what can go wrong in a process. [This answer is incorrect. A *control* addresses the risk of what could go wrong in the process, and by doing so it either prevents, or detects and corrects, misstatements that could occur as a result of processing the transaction. However, while an indirect control is a control, there is a better and more specific description available in a different answer choice.]

    c. A control that is important to preventing, or detecting and correcting, misstatements in a relevant assertion. [This answer is incorrect. This describes a *key control.* Indirect controls are not as likely to be key controls.]

    d. Controls that the controls to be tested depend on. [This answer is correct. According to AU-C 330.10, when designing and performing tests of controls, the auditor should determine whether the controls to be tested depend on other controls (indirect controls) and, if so, whether it is necessary to obtain audit evidence supporting the operating effectiveness of those indirect controls.]

15. Which of the following is considered a test of controls? **(Page 80)**

    a. Client acceptance procedures. [This answer is incorrect. Procedures and conclusions reached regarding client acceptance or continuance may provide evidence regarding management's ethical values, operating philosophy, integrity, and competence. These are considered *pre-engagement activities,* not tests of controls.]

    b. Use of a Type 2 service auditor's report. [This answer is incorrect. A service auditor may apply tests of controls at a service organization and report on whether the controls are operating effectively to achieve specified control objectives. Using this report, however, would not be considered a test of controls. Instead, this report is a source of evidence about operating effectiveness.]

    c. Walkthroughs. [This answer is correct. Tests of controls (either manual or automated) ordinarily include procedures such as (1) inquiries of appropriate personnel; (2) observation of the control being performed; (3) inspection of documents, reports, or electronic files; (4) walkthroughs; (5) reperformance of the control; and (6) review of reconciliations/bookkeeping routines.]

    d. Further audit procedures. [This answer is incorrect. Further audit procedures performed for the purpose of detecting material misstatement at the relevant assertion level are referred to as *substantive procedures,* not tests of controls.]

16. Which of the following statements best describes an aspect of performing tests of controls in an audit engagement? **(Page 83)**

    a. The objective of performing tests of controls is to eliminate the necessity of performing substantive procedures. [This answer is incorrect. The objective of performing tests of controls is to obtain sufficient appropriate audit evidence about their operating effectiveness to support the auditor's assessment of control risk.]

    b. Tests of controls can either be performed as of a point in time or over a specific period of time. [This answer is correct. AU-C 330.11 indicates that the auditor should test controls for the particular time or throughout the period of intended reliance.]

    c. Auditors can use evidence about operating controls from previous audits as long as they rotate it in and out on a five-year cycle. [This answer is incorrect. AU-C 330 explicitly recognizes that the auditor may be able to use audit evidence about the operating effectiveness of controls obtained in prior audits subject to certain defined restrictions. If these restrictions are met, the audit practice of rotating tests of controls over a three-year cycle might be used. A five-year cycle would be too long.]

    d. Tests of controls must be performed independently from tests of details on the same transaction. [This answer is incorrect. AU-C 330.A24 explains that the auditor may perform a test of controls concurrently with a test of details on the same transaction. This is considered a dual-purpose test.]

17. Which of the following is an efficiency that the auditor can gain when testing controls? **(Page 90)**

    a. Assess control risk as low instead of moderate when possible. [This answer is incorrect. To be more efficient, the auditor should not attempt to assess control risk as low if an assessment as moderate will support the planned extent of substantive procedures. An assessment of control risk as low normally requires obtaining more evidence than will an assessment of moderate.]

    b. Limit the use of walkthroughs as much as possible. [This answer is incorrect. Using inquiry, observation, and walkthroughs to the maximum extent possible as tests of controls will be more efficient for the auditor.]

c. Perform tests of controls independently from procedures for obtaining an understanding of controls. [This answer is incorrect. To save time (and be more efficient), the auditor should consider planning to perform tests of controls at the same time as performing procedures to obtain an understanding of controls or performing a dual-purpose test. AU-C 2330.A23 indicates that it may be efficient to test the operating effectiveness of controls at the same time as evaluating their design and obtaining audit evidence of their implementation, and AU-C 330.A24 indicates that the auditor may design a test of controls to be performed concurrently with a test of details of the same transaction.]

d. Use reconciliations rather than inspecting documents when possible. [This answer is correct. To test controls more efficiently, the auditor should consider using reviews of reconciliations and similar bookkeeping routines to the extent appropriate. This can be a more efficient, nonsampling test of controls than inspection of documents or reperformance of control procedures.]

THE EVALUATION OF TESTS OF CONTROLS AND THE ASSESSMENT OF CONTROL RISK

After performing tests of controls, the auditor evaluates the results of the tests and the persuasiveness of the evidence obtained in reaching a control risk assessment for a particular audit area and assertion. The control risk assessment can be at high for some or all assertions and at less than high for others. It is not necessary to attempt to assess control risk as low if an assessment as moderate will support the planned extent of substantive procedures. An assessment of low control risk will require obtaining more audit evidence than will an assessment of moderate control risk.

The results of control tests may support a planned control risk assessment of moderate or low, or the results may cause the auditor to reconsider the planned control risk assessment. AU-C 315.32 indicates that if audit evidence obtained from performing further audit procedures (tests of controls) is inconsistent with audit evidence on which the original risk assessment was based, the auditor should revise the risk assessment and modify further planned audit procedures. Thus, if the actual assessment supported by the control tests differs from the planned risk assessment, the auditor should consider adjusting the planned extent of substantive procedures. The adjustment of substantive procedures is a necessary matter of audit effectiveness (to prevent underauditing) if the actual control risk assessment is higher than the planned risk assessment, but is only a matter of audit efficiency (to prevent overauditing) if the actual control risk assessment is lower than the planned assessment. As the audit progresses, the auditor continues to evaluate whether audit evidence from performing substantive procedures suggests a need to reconsider the control risk assessment. The remainder of this section includes guidance on the auditor's evaluation of evidence from tests of controls, the amount of evidence needed to support a reduced control risk assessment, and the effect of the control risk assessment on substantive procedures.

Evaluating the Evidence about Operating Effectiveness

Tests of controls may detect deviations from prescribed procedures. AU-C 330.A44 indicates the concept of operating effectiveness of controls recognizes that there may be some deviations in the way controls are applied by the entity. Deviations might be caused by the following factors:

- Changes in personnel.
- Human error.
- Significant fluctuations in the volume of transactions.

It is important for the auditor to not draw an immediate conclusion about the operating effectiveness of a control when a deviation is detected. A deviation due to a single control deficiency does not necessarily mean that control risk is high. Controls are normally evaluated as a group. Other strong or effectively operating controls might compensate for the weak or ineffectively operating one. However, AU-C 330.A74 indicates that an auditor cannot assume that an instance of fraud or error is an isolated instance; careful analysis needs to be made to determine how it may affect the assessed risk of material misstatement. Therefore, the auditor should understand the cause of any deviation and its implication by making specific inquiries. In some cases, a deviation in a control activity might result from the ineffective operation of an indirect control such as the control environment or IT general controls. In such cases, to understand the deviation, the auditor may make inquires or perform other tests related to indirect controls. According to the AICPA Risk Assessment Audit Guide (paragraph 6.80), if fraud is the cause of the deviation, the severity of the control deficiency related to the deviation is elevated, and a broader analysis is ordinarily required than if error is the cause.

Based on the test results, the auditor determines whether:

- Tests results provide an appropriate basis for reliance on controls.
- Additional tests of controls are necessary.
- Potential risks of misstatement need to be addressed using substantive procedures.

For example, if the tests of controls result in finding deviations, the auditor may be able to support a reduced control risk assessment by expanding the test of controls after first understanding and isolating the nature of the deviations and their potential implications, or by testing other controls that accomplish the same objective as those being tested. If the auditor determines that the tests indicate that reliance cannot be placed on the controls, no further testing would be performed. At that point, the auditor would reassess the risk of material misstatement and the response through substantive procedures. However, even if the results of the tests support an assessment of control risk at a lower level, the auditing standards require auditors to design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. Thus, some substantive procedures are always necessary.

Sampling in Tests of Controls. If sampling is used in tests of controls, the auditor compares the number of deviations detected to the number of allowable deviations established when planning the procedure using sampling. When the deviation rate in the sample exceeds the expected deviation rate used in planning the sample, the auditor has to evaluate the effect on substantive procedures. An efficient and effective approach is to proceed as follows:

- First, obtain a good understanding of the nature and cause of the deviations.
- Second, consider whether other controls exist that mitigate the deficiency fully or partially. Understand and test the other controls to determine whether the control objective is achieved.
- Finally, assess the likelihood and magnitude of the misstatements that would be prevented or detected because of the control deficiency.

PPC's Guide to Audits of Nonpublic Companies more fully discusses sampling for tests of controls. The conclusion about the effectiveness of the controls tested can be documented using a form, such as the one provided in *PPC's Guide to Audit Risk Assessment*, or in a memo. Documentation considerations were more fully discussed earlier in this lesson.

Evaluating the Operating Effectiveness of Controls at a Service Organization. In situations in which an entity uses a service organization, the auditor may decide to or need to rely on controls that are maintained and implemented by the service organization. As discussed in *PPC's Guide to Audits of Nonpublic Companies*, the auditor obtains evidence about the operating effectiveness of relevant service organization controls in various ways.

Considering Evidence from Substantive Procedures. Substantive procedures may provide additional evidence that either supports the auditor's conclusion about the operating effectiveness of controls or creates the need to reevaluate the prior assessment of control risk. When evaluating the operating effectiveness of controls, auditors are required to evaluate whether misstatements detected by substantive procedures indicate that controls are not operating effectively. AU-C 330.A43 further indicates that the auditor's identification of a material misstatement of the financial statements when that material misstatement would not have been identified by the entity's internal control is a strong indicator of a material weakness. Auditors should be aware, however, that a lack of misstatements detected by substantive procedures does not provide audit evidence about the operating effectiveness of controls.

Communicating Control Deficiencies. AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*, establishes requirements for auditors to communicate certain identified control deficiencies during the audit. Control deficiencies that are significant deficiencies or material weaknesses should be communicated in writing to management and those charged with governance. In addition, AU-C 265.12 explains that the auditor also should communicate in writing or orally, to management other deficiencies in internal control identified during the audit not communicated to management by others that are of sufficient importance to merit management's attention. If the communication of other deficiencies is oral, the auditor should separately document the communication. The results of control testing, as well as the evaluation of design and implementation required in understanding internal control, are potential sources of identified control deficiencies. Identified deficiencies should be evaluated as to whether they represent, individually or in combination with other deficiencies, significant deficiencies or material weaknesses that are required to be communicated.

Considering the Amount of Audit Evidence Necessary to Support a Control Risk Assessment

AU-C 330.09 notes that, when designing and performing tests of controls, the auditor is required to obtain more persuasive audit evidence as the degree of reliance on the effectiveness of a control increases. AU-C 330.A27 further indicates that a higher level of assurance about the operating effectiveness of controls may be desired when the audit plan consists primarily of tests of controls, especially when it is not possible or practicable to obtain sufficient appropriate audit evidence from only substantive procedures. Thus, in choosing procedures to test a control activity, the auditor considers the degree of assurance provided by the procedure in relation to the degree of assurance needed to support a control risk assessment and reduction of substantive procedures. If there is a choice, the auditor would choose the available testing procedures that are most efficient in providing the needed degree of assurance. The following paragraphs discuss factors that affect the assurance provided by particular tests of controls.

Audit evidence varies substantially in the assurance it provides the auditor in developing an assessment of control risk. Professional standards do not specify the amount of audit evidence needed to assess control risk at less than high. They do indicate, however, that when more persuasive audit evidence is needed about the effectiveness of a control, increases in the extent of control testing may be warranted. The quantity and persuasiveness of audit evidence that is sufficient to support a specific risk assessment depends on consideration of factors such as the following:

a. The type of evidence obtained.

b. The source of the evidence.

c. The timing of obtaining the evidence.

d. Whether other evidence related to the risk assessment exists and supports or contradicts the same conclusion. This includes the following:

   (1) Evidence that may have been obtained about the entity and its environment or while gaining an understanding of the design and implementation of controls.

   (2) Evidence that may have been obtained about another control component, of the five control components. For example, the control environment is pervasive, and a good (or poor) control environment may positively (or negatively) affect the effectiveness of other control components.

These factors are discussed beginning in the following paragraphs.

Type of Evidence. The nature and types of control tests are discussed later in this lesson. AU-C 330.A29 explains that the nature of the control being tested will generally direct the type of procedure necessary to obtain audit evidence about operating effectiveness. For some controls, evidence about their design or operation can exist in documented form that the auditor may inspect. Usually, the knowledge and objectivity of the person who performed the control activity being tested by document inspection or reperformance are less critical to the auditor because there is objective evidence of the performance of the control and its result. This is in contrast to inquiry as a testing procedure, in which case the respondent's knowledge or objectivity may affect the reliability of the response.

Document inspection and reperformance of a control activity do not always provide conclusive evidence. Just because the auditor inspects a notation purporting to evidence performance of a control activity, or reperforms a control with no errors or exceptions being found, does not necessarily mean that the person who made the notation actually performed the control activity. For example, suppose the auditor inspects a clerk's initials on invoices purporting to indicate that the clerk traced the quantities billed to shipping reports. The auditor traces the quantities from the invoices to shippers and finds no exceptions. Still, the initialed invoices and auditor's successful tracing of the quantities to the shippers does not necessarily mean that the clerk had in fact examined the shippers.

Another problem with document inspection is that employees may perform a control activity but may not initial or place another identifying mark on documents to indicate that they did perform the activity. In such a situation, even though the control activity was performed, there is no documentation of that fact for the auditor to examine. In such a situation, document inspection cannot be counted as a source of evidence.

For some controls, there is no documentation of design or operation. For example, there may be no documentation of segregation of duties or control activities performed by the IT system. In such cases, the auditor may have to use a combination of inquiry, observation, or CAAT to obtain evidence about the design or operation. For example, the auditor might inquire about them and observe the receptionist opening the mail and listing cash receipts before sending the receipts to the accounting clerk.

Exhibit 2-9 summarizes key considerations for evaluating the types of evidence obtained from the control testing procedures discussed earlier in this lesson.

Exhibit 2-9

Types of Evidence Considered in Assessing Control Risk

Types of Evidence	Common Uses	Limitations	Examples of Controls Being Tested
Inquiry and observation	Especially useful in assessing the effectiveness of controls that do not leave a documentary trail of their performance.	Persuasiveness is sometimes limited because the evidence may only apply to the period of time the auditor is present.	• Segregation of duties, especially where there is no documented or other system evidence of performance. • Controls over counts of physical inventory. (Inspection of documents might also be used.)
Inspection of client documents (including reconciliations and other routines)	Can provide strong evidence about operating effectiveness, especially for controls relating to reconciliations and other documented routines.	Degree of persuasiveness depends on the extent of procedures (sample sizes, number of months reviewed, etc.). Primarily used to test controls that leave a documentary trail of their performance.	• Review of cash account reconciliations. • Independent review and approval of journal entries and supporting documentation prior to posting. (Reperformance might also be used in each example.)

Types of Evidence	Common Uses	Limitations	Examples of Controls Being Tested
Reperformance	Can provide strong evidence about operating effectiveness, especially when used with document inspection tests.	Degree of persuasiveness depends on the extent of procedures (sample sizes, number of months reviewed, etc.). Can be very time-consuming.	• Controls over the matching of invoices, receiving reports, and purchase orders. • Management review and approval over analyses of A/R allowances, other reserves, and estimates. (Inspection of documents would also be used in each example.)
Walkthroughs	May be useful in evaluating the design and implementation of controls.	The degree of persuasiveness depends on the extent of other evidence obtained about operating effectiveness.	• When obtaining an understanding of internal control, a walkthrough of a credit sales transaction is performed from the receipt of the customer order through recording in the general ledger; that involves the use of inquiry, observation, inspection of documents, and reperformance, where applicable, of key control activities.

Types of Evidence	Common Uses	Limitations	Examples of Controls Being Tested
Previous audits	Tests of controls from previous audits may provide evidence about the operating effectiveness of controls.	Persuasiveness is sometimes limited because controls may have changed since the previous audit.	• For the 20X1 engagement, the auditor tested controls over the review of inventory standard costs and variances. For 20X2, the auditor decides to use that evidence to support a reduced control risk assessment. The auditor obtains appropriate audit evidence regarding whether changes have occurred in those specific controls and the surrounding circumstances.

* * *

Source of the Evidence. Evidence about controls obtained directly by the auditor generally provides more assurance than evidence obtained indirectly. For example, evidence obtained by observation generally provides more assurance than evidence obtained by inquiry. In the first case, the auditor observes a control procedure being performed; in the second case, the auditor is merely told that it was performed. In any event, inquiry alone is not sufficient to test the operating effectiveness of controls.

Observation is generally superior to inquiry, but the auditor needs to keep in mind that the observed control activity might not be performed in the same manner when the auditor is not present. Generally, the stronger the control environment is, the more likely it is that the observed activity is performed consistently at times when it is not observed. Thus, the stronger the control environment, the more persuasive is evidence provided by observation. Also, more evidence can be obtained by performing the observation several times during the period. Similarly, the strength of inquiry as a source of audit evidence can be increased by asking more than one person about the same control.

Evidence obtained from externally produced documents, records, or reports is more persuasive than evidence from ones produced internally. The internally produced documents, records, or reports may have a greater potential for being subject to bias than externally produced ones. However, operational data and reports produced internally, but apart from the accounting and financial reporting function, such as an inventory manager's reports of units shipped or internal auditors reports, can have a "quasi-independent" nature. Also, evidence from internally produced documents is more persuasive if the control environment is strong.

Considering Evidence about the Operation of Entity-level Controls. Considering evidence about the operation of properly designed and implemented entity-level controls may contribute to the auditor's control risk assessment, and in some cases, affect the extent of detail control tests that are needed. This is either because the entity-level control sufficiently addresses the risk related to the relevant assertion, or because the entity-level control provides some assurance so that the testing of other controls related to that assertion can either be reduced or supplemented to further reduce the control risk assessment. In short, the consideration of entity-level controls can result in increasing or decreasing the testing the auditor otherwise would have performed on other controls. For example:

- The auditor might be able to further reduce the control risk assessment for an assertion by considering evidence about the operation of entity-level controls in addition to other control tests.
- In order to achieve a planned control risk assessment, the auditor might be able to reduce the extent of tests of key control activities by considering evidence about the operation of the control environment or monitoring components of internal control.
- The auditor might be able to reduce the control risk assessment based solely on evidence about the operation of entity-level controls. For that to be appropriate, the entity-level controls need to operate at a level of precision that, without the need for other controls, sufficiently addresses the risk of material misstatement to a relevant assertion.

In some situations where a control activity and an entity-level control function together to prevent, or detect and correct, material misstatements, the auditor may consider it necessary to obtain evidence about the operating effectiveness of both controls. For example, a key control activity for completeness might be provided by a reconciliation routine that includes investigation and resolution of items that were not posted to the general ledger account. Due to the inherent risks for the account and the volume and complexity of reconciliations, a monitoring control consisting of management review over the timely and proper completion of the reconciliation is important to minimize risk relating to completeness. In this case, the auditor may test both controls.

When evidence about the operation of an entity-level control contributes to a lower control risk assessment, in determining the extent of tests of the entity-level control to support a planned control risk assessment the auditor considers factors such as:

- How directly the entity-level control contributes to the achievement of the control objective related to the assertion.
- The evidence obtained during the performance of risk assessment procedures and its persuasiveness.
- The planned control risk assessment desired.

Example Using Evidence from Entity-level Controls. Assume that a key control over the accuracy of accounts receivable is provided by the daily review and resolution of a suspense account representing cash collections that could not be posted to the receivables subsidiary ledger due to missing or incorrect remittance information. For each day, the collection resolution clerk (a) reviews the suspense account, (b) investigates outstanding items, (c) makes appropriate corrections resulting in the clearing of the suspense account and posting to the subsidiary ledger (or reclassification of the receipt), and (d) documents the work performed. A monitoring control also exists where, at the end of each month, the controller ensures that the daily resolution control operates by reviewing the documentation of the daily resolution activity. The controller takes appropriate corrective action if the control was not properly and completely performed and documents the results of the review. The auditor has a planned expectation of operating effectiveness of the activity-level control and wishes to support a low control risk assessment.

When planning the tests of controls, the auditor notes that to support a low control risk assessment, a sample of 40 items would be required for the key suspense resolution control if no deviations were expected. However, a low control risk assessment might also be supported if the auditor tests a sample of 25 items for the key control activity and also tests three months of the controller's monthly monitoring review. A sample of 25 items with no expected deviations would normally support a moderate planned control risk assessment. However, with the evidence about the effective operation of the monthly monitoring control, the auditor may conclude that the low control risk assessment is supported.

Assessing Control Risk at Reduced Levels Based on Risk Assessment Procedures. Many of the procedures commonly used in the risk assessment process to gain an understanding of internal control (such as inquiry, observation and inspection, and walkthroughs) also may provide evidence about the controls' operating effectiveness. AU-C 330.A23 notes that some risk assessment procedures though not specifically designed as tests of controls, may nevertheless provide audit evidence about operating effectiveness and function as tests of controls.

According to AU-C 315.A77, obtaining an understanding of controls is not sufficient to serve as testing operating effectiveness, unless there are effective IT general controls and some automation that provides for the consistent application of the control. In other words, tests of controls need to be performed to support operating effectiveness. And those tests need to provide audit evidence about how controls were applied throughout the period of reliance and the consistency with which they were applied. However, it is possible that there may be circumstances when procedures performed to understand the design and implementation of controls may serve as tests of controls and support a reduced control risk assessment even in the absence of automation. The following examples illustrate the use of risk assessment procedures to support a reduced control risk assessment.

One example is the procedures performed to obtain an understanding of the control environment, such as inquiring about management's use of budgets, observation of management's comparison of actual and budgeted expenses, and inspection of reports about the investigation of and response to variances from the budget throughout the period under audit. These procedures may not only provide evidence about the design and use of budgets as a control, but also provide evidence that the budget policies and procedures are operating effectively enough (that is, applied at a sufficiently detailed level) to prevent, or detect and correct, misstatements in the financial reporting of expenses. This evidence may support a reduced control risk assessment for certain assertions related to expenses based on the auditor's consideration of whether the audit evidence provided by the procedures is sufficient.

Another example, is that in gaining an understanding of the monitoring component, the auditor might review reconciliations to determine whether they have annotations documenting that they were reviewed. This would constitute a test of that control during the period under audit. Similarly, procedures performed to gain an understanding of the information and communication process, such as questioning employees involved in accounting and computer processing and examining source documents and computer output at various stages in the accounting process throughout the period under audit, might constitute tests of the information and communication control component.

As an additional example, because of the inherent consistency of IT processing, performing risk assessment procedures to gain an understanding of an automated control (that is, to determine whether the control has been implemented) may serve as a test of the control's operating effectiveness, depending on the auditor's assessment and testing of IT general controls such as computer security and program change controls.

Finally, best practices indicate that it may be possible to support a control risk assessment of moderate based on procedures performed to evaluate the design of controls and determine that they have been implemented, when those procedures also constitute tests of controls. For example, in some cases a walkthrough can serve as a test of controls and along with other risk assessment procedures provide a valid basis for assessing control risk at less than high. Best practices indicate that such tests will generally not support a control risk assessment of low unless there is some automation that provides for the consistent application of the controls. Best practices also indicate that when determining whether risk assessment procedures are sufficient to support a reduced control risk assessment, consideration should be given to the nature of control (and overall control objective), the frequency of its operation, and whether sufficient evidence has been obtained about how the control was applied throughout the period under audit.

Confusion about Tests of Details of Transactions

Inspection of documents and accounting records may be involved in both tests of controls directed toward operating effectiveness (if controls leave a documentary trail) and tests of details of transactions. For this reason, some auditors have equated tests of details of transactions and tests of controls. The difference is in the objective of the test and the nature of any exceptions. The mere fact that a transaction rather than a balance is being tested does not make the test a test of controls. For example, the inspection of invoices in support of additions to property, plant, and equipment is a *substantive* procedure. The objective of the test is to substantiate the balance of the property account by testing the transactions, i.e., the additions. The same principle applies to other types of transactions or balances. For example, if sales transactions are tested to substantiate total revenue without testing the effectiveness of control policies and procedures for processing sales transactions. It is the objective of the test and not whether it is applied to a class of transactions or a balance that determines whether the test is a test of controls or a substantive procedure. Additionally, exceptions when performing tests of details of transactions or balances are monetary in nature and result in a misstatement in terms of dollars. Material exceptions generate a proposed audit adjustment entry. In contrast, exceptions when performing tests of controls are measured as rate of noncompliance with the control procedure. When the rate of exceptions is too high, the control is not effective. The auditor's assessment of control risk would be changed and the auditor would determine an appropriate response to the modified risk assessment. Substantive procedures, including tests of details of transactions, are normally applied after the auditor has obtained an understanding of internal control, but substantive tests of details of transactions in the current period may contribute to the auditor's understanding in subsequent periods. Tests of details of transactions can be performed concurrently with tests of controls as discussed earlier in this course..

Effect of the Control Risk Assessment on Substantive Procedures

Substantive procedures are discussed more in depth later in this lesson. All else being equal, the lower the assessed level of control risk with respect to an audit area or assertion, the less rigorous substantive audit procedures can be. For example, the auditor documents the control risk assessment and the assessed risk of material misstatement, of which control risk is a part. The assessed risk of material misstatement affects the auditor's response. If control risk and the risk of material misstatement are assessed as high for a particular audit area or assertion, generally the auditor would document the plan to select procedures from the Extended Procedures (Procedures for Additional Assurance) section of the audit program to obtain additional assurance and address the higher risk level. If, on the other hand, risk of material misstatement is assessed as moderate, for example, because audit evidence supports a reduced control risk assessment, the auditor might decide (and document) that the basic audit procedures section will suffice.

When the control risk assessment (and, consequently, the combined risk of material misstatement) is reduced by performing tests of controls, reductions of the extent of substantive procedures might include the following:

- Applying an analytical procedure as a substantive procedure instead of a test of details. (As discussed later in this lesson, in some cases, substantive procedures might be limited to substantive analytical procedures.)

- Using a less effective analytical procedure, such as one based on data developed by the client internally rather than on data developed from external sources.

- Examining fewer items in a test of details, such as using a smaller sample size if sampling is used, such as sending fewer accounts receivable confirmations.

- Observing a physical inventory at fewer locations.

The practical implication of being able to use less rigorous audit procedures or reduce the extent of substantive procedures is increased audit efficiency.

Note that although a lowered control risk assessment may be a basis for reducing the extent of substantive procedures, substantive procedures cannot be omitted entirely for material items. AU-C 330.18 states the that "irrespective of the assessed risks of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, or disclosure." AU-C 330.A45 notes that this requirement reflects that judgment is involved in assessing risk and the inherent limitations in internal control, including management override of controls.

AU-C 330.A45 notes that this requirement reflects the judgment involved in assessing risk and the inherent limitations in internal control, including management override of controls.

Using the PPC Approach. As discussed in Lesson 1, the auditor selects an audit approach consisting of Limited Procedures, Basic Procedures, or Extended Procedures (Procedures for Additional Assurance) based on the assessed risk of material misstatement at the relevant assertion level. Reductions in the control risk assessment (and, consequently, in the assessed risk of material misstatement) may enable the auditor to select an audit approach that is effective and more efficient to respond to the assessed level of risk. There is no formula for how much reduction in the control risk assessment is needed to enable the auditor to choose Basic Procedures rather than Extended Procedures, but the guidelines in Exhibit 2-10 may be useful when making that determination. As indicated in Exhibit 2-10, a control risk assessment of moderate ordinarily does not affect the choice of audit approach as between Basic or Extended Procedures. However, it may allow the auditor to alter the extent of substantive procedures within a given audit approach, as discussed above. Only a control risk assessment of low can ordinarily change the auditor's chosen approach from Extended Procedures to Basic Procedures.

Exhibit 2-10

Guidelines for Reducing Substantive Procedures Based on a Reduced Control Risk Assessment

Characteristics of the Audit Area	Inherent Risk	Control Risk	Risk of Material Misstatement	Comments
Significant audit area that does *not* contain fraud risks or other significant risks.	High	High or Moderate Low	High Moderate	When inherent risk is high with no fraud risks or other significant risks, the Extended Procedures (Procedures for Additional Assurance) approach is recommended unless the control risk assessment can be reduced to low. A control risk assessment of low, which reduces the overall risk of material misstatement to moderate, may permit the auditor to respond using Basic Procedures.
Significant audit area that does *not* contain fraud risks or other significant risks.	Moderate	High Moderate or Low	Moderate Low	Regardless of the control risk assessment, the authors recommend performing at least the Basic Procedures for this level of inherent risk in significant audit areas, with no fraud risks or other significant risks.
Significant audit area that contains fraud risks or other significant risks.	High	High or Moderate Low	High Moderate	Regardless of the control risk assessment, the authors recommend performing Extended Procedures (Procedures for Additional Assurance) for audit areas or assertions that contain fraud risks or other significant risks. That is, even if the overall risk of material misstatement could be reduced to moderate by testing controls, tests of details or extended analytical procedures are ordinarily still necessary to respond to fraud risks or other significant risks. (Fraud risks and other significant risks ordinarily involve high inherent risk.)

Characteristics of the Audit Area	Inherent Risk	Control Risk	Risk of Material Misstatement	Comments
				The response to the significant risk or fraud risk can be targeted to the specific type of misstatement for which the risk exists. The response does not need to be a blanket expansion of audit work for the assertion or audit area. Basic, or even limited, procedures could be performed related to other aspects of the relevant assertion. For example, there may be a significant risk related to the existence of property, plant, and equipment because of a new project to self-construct assets. The response can be focused on self-constructed assets and less extensive procedures might be acceptable for other aspects of the existence assertion.

*   *   *

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

18. Carlos has just completed his tests of control in an audit engagement. What should he do next?

    a. Evaluate the test results and the evidence.

    b. Assess control risk at low, moderate, or high.

    c. Revise the original assessment.

    d. Adjust the planned substantive procedures.

19. Which of the following sources of evidence about controls is the strongest?

    a. Information about a control relayed by an employee.

    b. A single observation of a control.

    c. Information from internally produced documents.

    d. Information obtained from a client with a strong control environment.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

18. Carlos has just completed his tests of control in an audit engagement. What should he do next? **(Page 98)**

    a. Evaluate the test results and the evidence. [This answer is correct. After performing tests of controls, the auditor evaluates the results of the tests and the persuasiveness of the evidence obtained. This evaluation will help Carlos to reach a control risk assessment for a particular audit area and assertion.]

    b. Assess control risk at low, moderate, or high. [This answer is incorrect. There is a process Carlos must complete before he has enough information to assess the appropriate level of control risk.]

    c. Revise the original assessment. [This answer is incorrect. According to AU-C 315.32, when the auditor obtains audit evidence from performing further audit procedures or if new information is obtained, either of which is inconsistent with the audit evidence on which the auditor originally based the assessment of control risk, the auditor should revise the assessment and modify the further planned audit procedures accordingly. Therefore, such a revision would not be appropriate until later in Carlos's engagement.]

    d. Adjust the planned substantive procedures. [This answer is incorrect. If the actual assessment supported by the control tests differs from the planned risk assessment, the auditor should consider adjusting the planned extent of substantive procedures. However, since Carlos has not assessed control risk yet in this scenario, it is too early for him to make adjustments to his planned substantive procedures.]

19. Which of the following sources of evidence about controls is the strongest? **(Page 103)**

    a. Information about a control relayed by an employee. [This answer is incorrect. Evidence about controls obtained directly by the auditor generally provides more assurance than evidence obtained indirectly. Therefore, since the auditor was told about this evidence instead of seeing it for himself, this evidence provides less assurance.]

    b. A single observation of a control. [This answer is incorrect. The observed control activity might not be performed in the same manner when the auditor is not present. More evidence can be obtained by performing the observation several times during the period than by a single observation.]

    c. Information from internally produced documents. [This answer is incorrect. Evidence obtained from externally produced documents, records, or reports is more persuasive than evidence from ones produced internally. The internally produced documents, records, or reports may have a greater potential for being subject to bias than externally produced ones.]

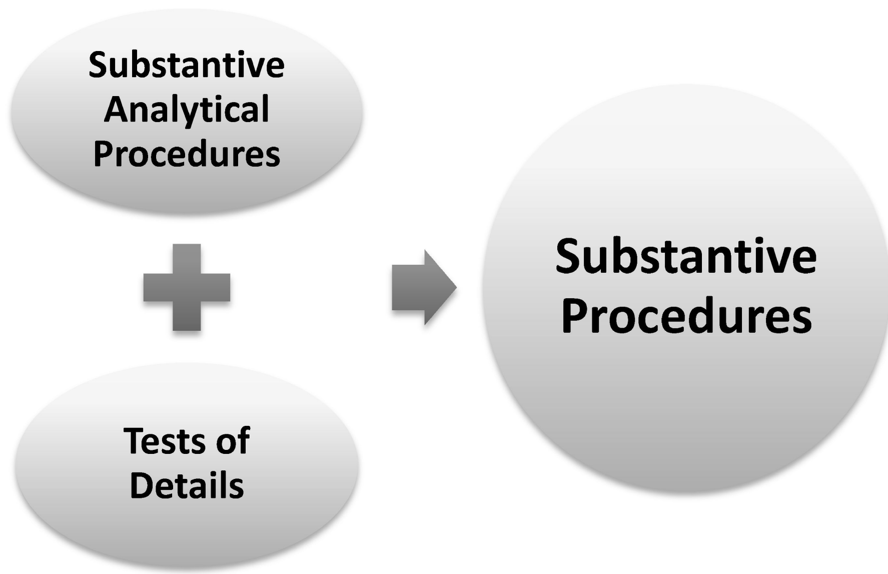
    d. Information obtained from a client with a strong control environment. [This answer is correct. Generally, the stronger the control environment is, the more likely it is that controls are performed consistently at times when they are not observed. Thus, the stronger the control environment, the more persuasive the evidence provided by observation.]

PERFORMING SUBSTANTIVE PROCEDURES

Further audit procedures performed for the purpose of detecting material misstatement at the relevant assertion level are referred to as substantive procedures. For each relevant assertion within a material account balance, class of transactions, or disclosure, the auditor needs to determine the nature, timing, and extent of substantive procedures necessary to obtain sufficient, appropriate audit evidence to express an opinion on the financial statements. Substantive procedures consist of tests of details and substantive analytical procedures as illustrated in Exhibit 2-11:

Exhibit 2-11

Substantive Procedures



*   *   *

Risk assessment procedures and tests of controls contribute to the formation of the auditor's opinion, but do not by themselves provide sufficient, appropriate audit evidence. According to AU-C 330.18, no matter what the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions for each material class of transactions, account balance, and disclosure. The reasons for this requirement are as follows:

- The auditor's assessment of risk is judgmental and might not be sufficiently precise to identify all risks of material misstatement.
- 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.

In other words, even if the auditor concludes that the risk of material misstatement is low for a particular assertion related to a material account balance, transaction class, or disclosure, based on performing risk assessment procedures and tests of controls, some substantive procedures are still required.

Certain substantive procedures should be performed in every audit. The additional substantive procedures that are needed in particular circumstances depend on the auditor's judgment about the sufficiency and appropriateness of audit evidence in the circumstances.

Substantive Procedures Required in Every Audit

Because of the judgmental nature of the auditor's risk assessments and the inherent limitations of internal control, particularly the risk of management override, as described above, the auditing standards prescribe certain substantive procedures that should be performed in every audit.

Financial Close and Reporting Process. AU-C 330.21 requires that the auditor perform the following substantive procedures related to the financial close and reporting process in every audit:

- Agree or reconcile the financial statements, including the accompanying notes, to the underlying accounting records. (AU-C 330.33 notes that the auditor's documentation should demonstrate that agreement or reconciliation.)
- Examine material journal entries and other adjustments made during the course of preparing the financial statements.

Management Override of Controls. AU-C 240.32 also requires certain substantive procedures in all audits to address the risk of management override of controls. These required procedures are as follows:

- Examine journal entries and other adjustments for evidence of possible material misstatement due to fraud, including:
  - Obtaining an understanding of the financial reporting process and controls over journal entries and other adjustments, and the suitability of design and implementation of those controls.
  - Inquiring of employees involved in the financial reporting process about inappropriate or unusual journal entry activity related to the processing of journal entries and other adjustments.
  - Considering fraud risk factors, the nature and complexity of accounts, and entries processed outside the normal course of business.
  - Selecting journal entries and other adjustments made at the end of the reporting period.
  - Considering the need to test journal entries and other adjustments made throughout the period.
- Review accounting estimates for bias that could result in material misstatement due to fraud, including:
  - Evaluating whether management's judgments and decisions, even if they are individually reasonable, indicate possible bias that may represent a material misstatement due to fraud and, if so, reevaluating the accounting estimates as a whole.
  - Performing a retrospective review of management's judgments and assumptions related to significant prior year accounting estimates.
- Evaluate the business rationale for significant unusual transactions.

Responding to fraud risks is discussed later in this lesson.

Both AU-C 330.21 and AU-C 240.32 require examining journal entries and other adjustments, but the requirement of AU-C 240.32 is focused on identifying fraudulent journal entries. As discussed in paragraph 6.89 of the AICPA Risk Assessment Audit Guide, the nature, timing, and extent of procedures required by AU-C 240 are different from those required by AU-C 330. AU-C 330 focuses on journal entries made during the course of preparing the financial statements and AU-C 240 requires the auditor to consider reviewing journal entries made throughout the year. This distinction is also emphasized in a nonauthoritative AICPA Technical Question and Answer, *Examining Journal Entries* (Q&A 8200.16). Auditors should ensure that their audit procedures satisfy both requirements.

Significant Risks. As discussed in Lesson 1, significant risks are risks that require special audit attention. When the audit approach to significant risks consists only of substantive procedures (that is, the auditor does not plan to rely on controls), the substantive procedures should be tests of details only or a combination of tests of details and substantive analytical procedures. The use of only substantive analytical procedures is not permitted. (AU-C 330.22)

When the auditor has determined that there is a significant risk associated with an accounting estimate, AU-C 540.15–.17 outline certain procedures that should be performed in addition to other substantive procedures performed to respond to the risks of material misstatement. The focus is on how management has assessed the effect of estimation uncertainty on the accounting estimate and how that uncertainty affects the appropriateness of the amount in the financial statements, as well as the adequacy of disclosures. The auditor is required to evaluate:

- How management considered alternative assumptions or outcomes and why it rejected them or how management otherwise addressed estimation uncertainty in making the accounting estimate (e.g., the use of a sensitivity analysis).
- Whether the significant assumptions used by management are reasonable.
- When relevant to the reasonableness of the significant assumptions used by management or the application of GAAP, management's intent and ability to carry out a specific course of action.

If the auditor deems that management has not adequately addressed the effects of estimation uncertainty, the auditor should, when necessary, develop a range to evaluate the reasonableness of the estimate. Furthermore, for accounting estimates that give rise to significant risks, the auditor is required to obtain sufficient appropriate evidence about whether management's decision to recognize, or not recognize, the estimate, as well as the measurement basis, are in accordance with GAAP. For example, in certain cases, GAAP may prescribe that amounts should not be recognized if they cannot be reasonably estimated or it is not practicable to estimate amounts. Even if amounts are not recognized under GAAP, there may be a need for disclosure of the circumstances in the notes to the financial statements. In some cases, there may be a need for the auditor to add an additional paragraph to the auditor's report to emphasize the matter.

Other Specific Requirements. There are also other presumptively mandatory requirements for substantive procedures for particular account balances. Examples include the following:

- Confirmation of accounts receivable. (AU-C 505.03)
- Inventory observation, that is, being present at the time of the count and, by suitable observation, tests, and inquiries being satisfied about the effectiveness of the methods of inventory taking. (AU-C 501.11)

In addition, there are other specific requirements to perform procedures, typically called *general procedures*, that do not relate to particular account balances, such as performing a review for subsequent events and reading minutes of meetings of directors. Those general procedures, as well as the required procedures listed above for financial close, the reporting process, and management override of controls, are included in the general audit programs. The requirements to confirm accounts receivable and observe inventory are basic procedures in those audit programs.

Sufficiency and Appropriateness of Audit Evidence

The additional substantive procedures that are needed in particular circumstances depend on the auditor's judgment about the sufficiency and appropriateness of audit evidence in the circumstances. Therefore, the auditor should consider the sufficiency and appropriateness of audit evidence to be obtained when assessing risks and designing further audit procedures. AU-C 500.05 describes these characteristics of audit evidence as follows:

- *Sufficiency* is the measure of the *quantity* of audit evidence.
- *Appropriateness* is the measure of the *quality* of audit evidence, that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.

The quantity and quality of audit evidence needed are interrelated and are dependent on the risk of material misstatement.

The auditor performs risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement. This assessment includes consideration of the effectiveness of management's responses and controls to address risks. The auditor evaluates the quality and quantity of the evidence obtained from the risk assessment procedures and, if applicable, tests of controls to determine the further audit procedures necessary to obtain sufficient, appropriate evidence to afford a reasonable basis for an opinion of the financial statements under audit.

An important quality of audit evidence is its reliability, which is affected by both the nature and source of the evidence. AU-C 500.A32 provides the following generalizations about the reliability of audit evidence:

a. Audit evidence is more reliable when it is obtained from knowledgeable independent sources outside the entity.

b. Audit evidence that is generated internally is more reliable when the related controls imposed by the entity are effective.

c. Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).

d. Audit evidence is more reliable when it exists in documentary form, whether paper, electronic, or other medium. For example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed.

e. Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies, faxes, or electronic images. Electronic images include documents that have been filmed, digitized, or otherwise transformed into an electronic form. The reliability of electronic images may depend on the controls over their preparation and maintenance.

AU-C 500.10 states that if audit evidence obtained from different sources is inconsistent or doubt exists about the reliability of information to be used as audit evidence, the auditor should determine what changes or additions to audit procedures are necessary to resolve the matter and consider the effects on other aspects of the audit. The auditor needs to be wary when explanations obtained from different sources conflict; management's explanations for significant fluctuations differ from the auditor's expectations; or responses to inquiries about analytical relationships are vague, implausible, or inconsistent with the auditor's knowledge or other audit evidence. In this area, the main ingredients for effectiveness are healthy doses of common sense and professional skepticism.

Authoritative literature views audit evidence as being obtained from a variety of sources, including the auditor's assessment of risk. AU-C 500.05 defines *audit evidence* as "information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information." Audit evidence includes evidence obtained from procedures performed during the current audit as well as previous audits. Use of audit evidence from previous audits is discussed elsewhere in this lesson, but one common form of such evidence is experience gained in previous audits with respect to potential misstatements. Misstatements detected in previous audits are an important indicator of likely misstatements in the current audit. Generally, however, previous misstatements are a more reliable indicator of error than fraud.

AU-C 500.05 notes that audit evidence includes the information contained in the accounting records underlying the financial statements and other information. AU-C 315.21 notes for material account balances, the auditor should obtain an understanding of the reconciliation process of comparing detailed records to the general ledger. Further, as described earlier in this lesson, agreeing the financial statements to the underlying accounting records is a required procedure in every audit. Thus, without adequate attention to the propriety and accuracy of underlying accounting data, an opinion on the financial statements is not warranted.

Nature, Timing, and Extent of Substantive Procedures

As the residual risk of material misstatement increases, the quantity and quality of necessary audit evidence from substantive procedures also increases. The higher the auditor's assessment of risk, the more reliable and relevant the audit evidence from substantive procedures needs to be. This may affect both the types of audit procedures to be performed and their combination.

Generally, the auditor will have decided whether audit procedures will be performed at an interim date or at period end as part of establishing the overall audit strategy. Therefore, in designing further audit procedures, the focus will be on the nature and extent of substantive procedures rather than their timing. AU-C 330.A5 notes that an important part of responding to the assessed risks is the nature of audit procedures. Generally, increasing the extent of an audit procedure is effective only if the audit procedure itself is relevant to the specific risk. Therefore, the nature of the audit procedure is the most important consideration.

Basic Types of Substantive Procedures

Substantive procedures have historically been classified and described based on their nature, as shown in Exhibit 2-12. This perspective is a sound approach to basic auditing, but it does not help auditors determine the most efficient audit approach for responding to risks. Selecting appropriate substantive procedures is discussed in the following paragraphs.

Exhibit 2-12

Substantive Audit Procedures (By Nature)

Procedure	Description	Examples
Inspection of tangible assets (physical examination)	Identification of an item's existence and sometimes its quality.	Test counts of inventory, cash count, securities count.
Confirmation	Obtaining a written response directly from independent parties outside the client organization in a paper form or by electronic or other means.	Confirming accounts receivable with customers.
Inspection of documents (which includes vouching and tracing)	Inspection of documents (vouching) that support recorded transactions or amounts. (Direction of testing is from recorded amount to the supporting document.) Tracing source documents to the amounts in the accounting records. (Direction of testing is from source document to recorded amount.)	Vouching recorded sales transactions to sales invoices and shipping documents for agreements. Tracing shipping documents to recorded sales in the accounting records.
Reperformance and recalculation	Auditor repetition of client routines or internal control procedures such as calculating and bookkeeping functions.	Determining that journal entries have been posted to the proper accounts; recomputing client depreciation calculations.
Inquiry	Questioning management, employees, or persons outside the entity (responses to which may be oral or written).	Asking if consignment arrangements exist; obtaining a client representation letter.

Procedure	Description	Examples
Analytical procedures (which includes scanning)	Systematic analysis and comparison of plausible relationships among absolute amounts, trends, and ratios. Visual scrutiny of accounting records, reports, and schedules (scanning) to detect unusual items, inconsistencies, or anomalies. Includes investigation of differences that are inconsistent with expected values.	Comparing gross margin percentages over time; relationship of bad debt write-offs to the accounts receivable balance. Scanning the charges to the repairs expense account for capital expenditures; scanning the December sales journal for unusual items.
Observation	Visually reviewing client activities or locations.	Observing bookkeeping routines; touring plant.

* * *

Selecting Appropriate Substantive Procedures

The selection of specific substantive procedures involves consideration of all relevant factors, including the following:

- Characteristics of the related account (or transaction class).
- Financial statement assertion(s) being tested.
- Nature of risks identified.
- Degree of the risk involved.
- Type and persuasiveness of the available audit evidence.
- Efficiency and effectiveness of the substantive procedures.

Considering the Account Being Tested. Some types of accounts lend themselves better to particular procedures. For example, some accounts, such as accounts receivable, can generally be tested by applying procedures to balances. Other accounts, such as property accounts, are often tested most effectively by examining transactions during the period. As another example, many types of accrued liabilities are based on financial relationships that can be effectively tested through properly designed analytical procedures.

Considering the Financial Statement Assertion. Similarly, the financial statement assertion being tested can also significantly affect the choice of procedures. For example, tests of existence are generally aimed at examining the items comprising the account balance. Tests of completeness often involve (a) performing predictive tests of account balances or (b) identifying items that should be included in the account and determining whether they are included. Tests of valuation normally relate to assessing the reasonableness of computed or estimated amounts (such as inventory costing or allowance for doubtful accounts).

The financial statement assertion being considered can also provide indications of the types of misstatements that might occur in the financial statements. For example, misstatements of the existence assertion generally result in overstatement of the account balance, and misstatements of the completeness assertion generally result in understatement.

Considering the Nature of Risks Identified. The auditor should document specific risks relating to each significant audit area and related assertion, including fraud risks and other significant risks. Sometimes the identified risk will suggest the appropriate additional procedure needed. For example, if the risk for receivables is that sales cutoff errors are likely to occur, the auditor may simply choose to apply more procedures to test sales cutoff. However, in other cases, the appropriate procedure may be less clear. In those cases, the auditor should consider the risks in terms of the types (or direction) and causes of potential misstatements to decide what steps may be appropriate. Exhibit 2-13 lists the basic types (or direction) and causes of misstatements that might affect a particular account and result in material misstatement of the financial statements.

Exhibit 2-13

Types (Direction) and Causes of Misstatements

Types (Direction) of Misstatement

- Understatement of account balance
- Overstatement of account balance

Causes of Misstatement

- Error
- Fraudulent financial reporting
- Theft

* * *

Determining the type of misstatement can help the auditor determine the direction of the testing procedures. To illustrate this process, consider how types of misstatement could affect the testing of inventory quantities. If the auditor is concerned about understatement of inventory quantities, the focus should be on tracing from external documents (purchase records, physical inventory counts, etc.) to the inventory records and testing to assure that all inventory was counted. On the other hand, if the auditor is concerned about overstatement of quantities, the focus would be on (a) vouching recorded quantities to physical count sheets or other relevant documentation, (b) testing to assure that inventory counts were not duplicated, and (c) determining whether purchased inventory in transit was recorded in the proper period.

The auditor also considers whether the likely cause of misstatements will tend to result in understatement or overstatement of the account balance and designs procedures accordingly. For example, if fraud risk indicators point to a risk of overstatement of revenue, one possibility is an increased risk of improper cutoff to inflate revenue. Thus, the auditor might design procedures to compare sales recorded near year end to merchandise shipments with the emphasis on whether shipments after year end were incorrectly recorded as sales in the period under audit.

Consideration of the cause of misstatements becomes especially important if the auditor believes there is a significant risk of material misstatement due to fraud. In that case, the auditor carefully considers how fraud might result in misstatement of the financial statements and then designs appropriate procedures to detect those misstatements.

Considering the Degree of Risk. The auditor should document the assessment of the risk of material misstatement for each significant audit area or assertion. Generally, the higher the risk, the greater the degree of assurance needed from substantive procedures. Even without testing controls, the degree of assurance can be increased through one or more of the following means:

- *Nature.* The auditor can change the nature of the procedures. This normally involves adding more procedures or choosing more persuasive procedures, that is, using more targeted procedures, performing more independent verifications, etc.

- *Extent.* The auditor can increase the extent of testing. This can be done by testing more items, changing the design of the test to focus on more items that are prone to misstatement, or increasing the precision of analytical procedures.

- *Timing.* The auditor can change the timing of the procedures to do more work at the balance-sheet date.

Because audit programs deal primarily with the nature of procedures, an auditor's first response to a high risk of material misstatement will normally be to consider adding more procedures. Before doing so, the auditor needs to consider whether or not he or she is performing the most effective or the correct procedures. Then, the auditor considers whether changing the extent or timing of the procedures might be as effective as, and more efficient than, adding different audit procedures. If the auditor responds to a high risk of material misstatement by altering the extent or timing of the procedures, he or she should document that response.

Considering the Available Evidence. When planning the audit, the auditor considers the audit evidence needed and the evidence available. The evidence sought needs to be commensurate with the assessed level of risk. Generally, the higher the assessed risk of material misstatement for an area or assertion, the more reliable the evidence needs to be. The relative reliability of audit evidence was discussed earlier in this lesson.

The availability of audit evidence is another key consideration. This is critical when much of that evidence is electronic. In many entities, vast amounts of information are transmitted, processed, maintained, or accessed electronically. In some industries, purchase and sale transactions and related payments occur electronically, such as through electronic data interchange (EDI). When information technology systems are used extensively, some audit evidence may be available only in electronic form and only for a period of time. In those situations, the auditor can only apply the audit procedures when the evidence is available and might need to use technology to do so. Sometimes, the auditor might conclude that it is not possible or practical to reduce detection risk at the relevant assertion level to an acceptable low level with audit evidence obtained by performing only substantive procedures. In those cases, the auditor should test controls relating to those assertions.

Considering the Effectiveness and Efficiency of Substantive Procedures. As previously noted, the auditor considers the degree of assurance needed from substantive procedures and selects procedures that are sufficiently effective. To be cost-effective, the auditor also considers efficiency of the substantive procedures.

Substantive procedures include tests of details, substantive analytical procedures, or a combination of both. Therefore, designing the nature of substantive procedures involves deciding between or combining the two. In some cases, substantive procedures might be limited to substantive analytical procedures. Substantive analytical procedures alone are more likely to be appropriate in the following circumstances:

- The risks of material misstatement, including particular risks due to fraud, are relatively low.

- The account balance, transaction class, or disclosure relates to large volumes of transactions that tend to be predictable over time.

- The account balance, transaction class, or disclosure is not affected by a significant degree of subjectivity.

Choosing between Substantive Analytical Procedures and Substantive Tests of Details

Authoritative literature does not explain how to apportion reliance on substantive procedures between tests of details and analytical procedures, except for the prohibition on against using substantive analytical procedures alone when testing significant risks as discussed earlier in this lesson. Analytical procedures may be used to reinforce conclusions based on the results of other substantive procedures or as the sole source of evidence. That decision is primarily based on the effectiveness of the procedures. Efficiency also may be a factor in deciding between analytical procedures and tests of details. That is, given two procedures of equal effectiveness, the auditor chooses the one that is most efficient. Therefore, the auditor would ordinarily use an analytical procedure rather than a test of details if the analytical procedure is at least as effective in reducing detection risk to the desired level as the test of details and is easier to apply.

According to AU-C 520.05, in designing substantive analytical procedures, the auditor should consider matters such as the following:

a. The suitability of using substantive analytical procedures, given the assertions.

b. The reliability of the data, whether internal or external, from which the expectation of recorded amounts or ratios is developed. [AU-C 500.09 indicates the auditor should obtain evidence about the accuracy and completeness of information (both financial and nonfinancial) used in performing substantial analytical procedures.]

c. Whether the expectation is sufficiently precise to identify a material misstatement at the desired level of assurance.

d. The amount of any difference between recorded amounts and expected values that is acceptable.

Generally, the higher the assessed risk of material misstatement of a particular assertion, the more effective analytical procedures need to be before they can be relied on instead of tests of details. Accordingly, auditors tend to use tests of details more extensively in high risk audit areas (such as areas containing fraud risks or other significant risks) and analytical procedures more often in low risk areas or as secondary rather than primary auditing procedures. However, if the auditor performs highly effective analytical procedures, it may be possible to reduce the extent of detail testing even in areas in which significant risks exist. The effectiveness of analytical procedures in reducing detection risk in comparison with the effectiveness of tests of details generally depends on the evaluation of the considerations listed earlier in this section. The following general observations are useful in evaluating the suitability of using substantive analytical procedures given the assertion to which the procedures are directed:

a. Analytical procedures are generally not effective in testing assertions about rights or obligations or assertions related to presentation and disclosure because those assertions do not lend themselves to testing through comparisons with expectations. For example, analytical procedures would not be effective responses for risks related to matters such as parties to transactions lacking in economic substance or intentional ambiguity in financial statement disclosures.

b. Relationships involving transactions over a period of time (that is, income statement accounts) tend to be more predictable than relationships at a point in time (that is, balance sheet accounts). Because of the difficulty in developing expectations about a balance at a point in time with sufficient precision, analytical procedures are often not as effective as tests of details for assertions about the existence of assets and liabilities. For example, analytical procedures would not be as effective as tests of details when responding to risks such as potentially recording false receivables or including items in inventory that are false or mislabeled.

c. Analytical procedures are often equally or more effective than tests of details for assertions about the completeness of assets, liabilities, revenues, and expenses. When testing for completeness, misstatements would often not be apparent from inspecting detailed evidence in the accounting records. For example, the analytical procedure of comparing the change in inventory to recorded sales may be equally or more effective than testing daily sales reports in detecting a material misappropriation of cash sales receipts in a retail organization.

d. Analytical procedures are often equally or more effective than tests of details for assertions about the occurrence of revenues. For example, comparing recorded sales with the amount expected, based on a reliable record of units sold and average prices, especially if comparisons are made by product line, may be as likely to detect a material misstatement of assertions about the occurrence of revenues as inspecting supporting documentation for a sample of recorded sales. Analytical procedures are more reliable if they are based on reliable data produced outside the accounting system (for example, operating data used to manage the entity).

e. Analytical procedures are often equally or more effective than tests of details for assertions about the occurrence of certain expenses. For example, comparing recorded production labor costs with the amount expected, based on the number of people required for the volume sustained during the year, may be as likely to detect a material misstatement as looking at supporting documentation for a sample of recorded compensation expense. However, if fraud is a concern, analytical procedures may not be effective. For example, if management is able to manipulate expense accounts so that ratios appear reasonable, ratio analysis would not be an effective analytical procedure for detecting material misstatements.

f. Analytical procedures may be as effective as tests of details for assertions about the valuation of some assets and liabilities but not for others. Generally, whether an analytical procedure is as effective as a test of details for a valuation assertion depends on whether an expectation can be developed. For example—

   (1) An analytical procedure may be as effective as a test of details for assertions about the valuation of customer accounts receivable that are made up of a large number of relatively small balances. However, a test of details may be more effective when some account balances are disproportionately large. In that situation, failure to record an allowance for uncollectible amounts resulting from a deterioration in the financial condition of one of those customers either before or after year-end would most likely not be detected by an analytical procedure.

   (2) An analytical procedure may be as effective for valuation assertions about an entity's obligation under a continuing warranty program, but a test of details may be more effective for a new warranty program. In that situation, the newness of the program makes developing an expectation with the desired precision more difficult.

g. Substantive tests of details may be more effective for valuation assertions in an unstable environment. The ability to develop an expectation that approximates the recorded amount is greater when the environment is stable. For example, when interest rates are fluctuating widely, it is difficult to develop a precise expectation about interest expense. Similarly, when transactions involve management discretion, such as the choice of repairing versus replacing existing assets, there is also less predictability in expected relationships.

The other considerations for using substantive analytical procedures are discussed earlier in this section.

Substantive Procedures for Income Statement Accounts. A common approach to testing revenue and expense accounts has been to test extensively balance sheet accounts and to rely almost exclusively on substantive analytical procedures to test income statement accounts. This approach may not give sufficient consideration to the differences that can exist among revenue and expense accounts in particular circumstances with regard to risks of material misstatement, including significant risks at the assertion level. For example, the most efficient and effective audit approach for testing revenue is dramatically different when there is a fraud risk related to occurrence that would overstate revenue versus understate it, or when the risk of errors is due to the complexity of recognition rules. Also, substantive analytical procedures are more effective for some types of accounts than others.

Best practices suggest the following overall approach to testing these accounts in an efficient and effective manner and designing tests of details of individual transactions:

- Identify risks of material misstatement on the assertion level with as much specificity as possible. (For example, there is a risk of fraud related to the occurrence assertions that would overstate sales.)
- Consider the quality and extent of evidence provided from tests of other related accounts relevant to the assertion, particularly balance sheet accounts. (For example, confirmation of receivables for revenue or the search for unrecorded accounts payable for expenses.)
- Consider the evidence from substantive analytical procedures. (For example, given the identified risks, nature of the account, and the relevant assertion, do analytics provide persuasive evidence?)
- Consider the efficiency and effectiveness of testing controls. (For example, given the design of controls associated with the relevant assertion, would the controls, if operating effectively, along with evidence from preceding considerations reduce the extent of tests of details?)
- Design and apply tests of details of selected individual transactions based on the above considerations.

Timing of Substantive Procedures

As part of audit planning, the auditor considers whether any substantive procedures will be applied before the balance sheet date. When substantive procedures are performed at an interim date, AU-C 330.23 requires the performance of further substantive procedures (or substantive procedures combined with tests of controls) for the remaining period. Generally, the most efficient approach for audits of small and midsize nonpublic entities is to perform the audit tests as of the balance sheet date. Nevertheless, the auditor may wish to perform audit procedures before the balance sheet date in the following situations:

- *Convenience.* If the auditor has many clients with the same year end, interim procedures may be used to spread the auditor's workload more evenly.

- *Deadline.* If the client has a tight deadline for issuing its financial statements, the auditor may need to perform some procedures at an interim date to meet that deadline.

- *Issue Identification.* Interim audit work allows the auditor to identify and address critical audit issues as soon in the engagement as possible. Then the auditor and client can more easily deal with issues without deadline pressures arising near year end, which in turn can enhance audit efficiency and client relations.

- *Assessed Risks of Material Misstatement.* Modifying the timing of substantive procedures is one response to the assessed risks of material misstatement due to error or fraud. In general terms, the higher the assessed risk of material misstatement, the more likely it is that the auditor will determine that it is more effective (or necessary due to certain fraud risks) to perform substantive procedures near the period end. However, as the assessed risks diminish, the auditor may determine that an appropriate response would include the performance of certain substantive procedures at an interim date. Also, as AU-C 240.A43 points out, a response to some identified fraud risks, such as fraudulent revenue recognition, might be to apply substantive procedures to transactions occurring earlier in or throughout the reporting period. An overall response to identified risks might be to add an element of unpredictability in the timing of audit procedures from year to year, such as by performing tests at a time other than expected.

Many auditors find that the benefits of interim audit procedures outweigh the disadvantages. In many cases, there is simply no way to meet the audit firm's and clients' needs without some interim work. Thus, the issue often becomes not whether to do interim work but how to do it to maximize audit efficiency and effectiveness.

There are generally two types of substantive procedures that may be performed before the balance sheet date—

a. *Flexible Timing Procedures.* Flexible timing substantive procedures can be applied at any time, including an interim date. These procedures generally consist of examining transactions or gathering information without attempting to reach a conclusion about an entire account balance as of an interim date. The procedures can be performed through an interim date and later extended to the balance sheet date. The auditor can then reach one conclusion covering the balance for the entire year. Examples of such procedures include:

   (1) Tests of transactions in balance sheet accounts with a low turnover or activity rate, such as property, long-term debt, lease obligations, investments, and owners' equity.

   (2) Tests of transactions that affect revenues and expenses, such as tests of sales of significant assets.

   (3) Analytical procedures for revenues and expenses, such as analysis of sales or gross profit by month.

b. *Interim Audit Procedures.* Interim audit procedures are performed to arrive at a conclusion about an account balance as of an interim date. Additional procedures are then performed to extend the interim conclusion to the balance sheet date. The following are examples of procedures that may be performed at an interim date, depending on the circumstances:

   (1) Confirmation of accounts receivable.

(2) Inventory observation.

(3) Inventory price testing.

Interim audit procedures involve additional considerations, which are discussed in the following paragraphs.

Interim Audit Procedures. When evaluating whether it is practical to perform interim audit procedures, the auditor considers the following factors:

a. *Feasibility.* AU-C 330.A61 lists several factors that may be considered before applying substantive procedures at an interim date. Those factors include the control environment, when the necessary information is available, the nature of the account or transactions, the assessed risk, and the period to which the audit evidence relates. Also, there are practical considerations such as the availability of sufficient information to effectively test the remaining period (that is, the period from the interim date to the balance sheet date).

b. *Efficiency.* Interim substantive tests of details of asset and liability account balances may not be cost-effective unless substantive procedures covering the remaining period can be restricted. If testing of the remaining period cannot be restricted, the auditor may have to reperform the same procedures as of the balance sheet date, which could result in a substantial increase in audit time and cost.

Exhibit 2-14 provides a list of specific considerations when deciding whether to perform interim audit procedures.

Choosing an Interim Date. When interim audit procedures are performed, the risk that misstatement may exist in the related audit area and not be detected by the auditor generally increases as the length of the remaining period increases. Thus, the selection of an interim date (which determines the length of the remaining period) can significantly affect the nature and extent of audit procedures for the remaining period. GAAS does not specifically address selection of interim audit dates. Many auditors insist that the interim date not be more than three months before the balance sheet date. Generally, an interim date of one month before the balance sheet date is preferable. Ultimately, the choice of the "as of" date to be used as the interim date depends on the reasons for interim testing as described earlier in this section, and evaluation of the risk factors, account characteristics, features of the financial reporting system, and the efficiency and effectiveness of testing the remaining period, as explained in Exhibit 2-14 and the following paragraphs.

Exhibit 2-14

Timing Considerations for Interim Audit Procedures

1. **Risk factors**
   a. Assessed risk of material misstatement. (The higher the assessed risk of material misstatement, the more likely it is that the auditor will determine that it is more effective to perform substantive procedures near the period end or at unannounced or unpredictable times. Additionally, the response to some identified fraud risks may cause the auditor to perform substantive procedures at the balance-sheet date while the response to other identified fraud risks may cause the auditor to apply substantive procedures to transactions occurring earlier in or throughout the reporting period.)
   b. Length of the remaining period.
   c. Control environment and other relevant controls.
2. **Account characteristics**
   a. The relevant assertions for which audit evidence will be obtained.
   b. The predictability of changes in the composition or amount of the account balance from the interim date to the balance-sheet date.
   c. The probability of transactions or events occurring between the interim date and the balance-sheet date that could significantly affect the conclusions at the interim date or require the reperformance of interim audit procedures.

d. Client policies and procedures regarding the account (specifically, whether the client analyzes and adjusts the account balance regularly and establishes proper cutoffs).

3. **Financial reporting system**

   a. Reliability of the financial reporting system (for example, whether it is characterized by inaccuracy or delay that creates audit risks that would undermine the effectiveness of interim testing).

   b. Ability of the financial reporting system to provide sufficient information about the following matters:

      (1) Composition of the account balance at the interim date.

      (2) Composition of the account balance at the balance-sheet date.

      (3) Transactions occurring and journal entries recorded during the remaining period.

      (4) Reasons for significant differences arising from analytical procedures.

*   *   *

Audit Risk Considerations. When interim audit procedures are performed, there is a risk that the conclusions reached at the interim date cannot extended effectively to the balance-sheet date. This remaining period risk tends to rise with increases in the following factors:

- Assessed risk of material misstatement from either error or fraud.
- Length of the remaining period (that is, the period from the interim date to the balance-sheet date).

Generally, the greater the remaining period risk, the greater the assurance needed from tests of the remaining period. For example, if the remaining period risk is low, the auditor can generally test the remaining period through limited analytical procedures. However, if the remaining period risk is high, the auditor would generally need to apply more reliable procedures, such as tests of details. In some high-risk cases, the auditor might even need to reapply some of the interim procedures to period-end balances. When deciding whether and when to perform substantive procedures at an interim date, the auditor considers whether the tests that would be performed for the remaining period will adequately reduce the risk that misstatements that exist at period end are not detected.

Consequently, it may be more efficient to apply interim audit procedures to lower-risk areas or assertions. For example, if the client had a high risk relating to the allowance for doubtful accounts but moderate or low risk for existence, the auditor might decide to test existence at an interim date and valuation at the balance sheet date.

The auditor may also consider other factors that contribute to audit risk when determining whether and when to perform interim procedures, such as the control environment or the specific nature of the risk that applies to the audit areas or assertions. For example, if there is a risk of overstated revenues due to earnings pressures, the auditor may determine that the relevant assertions of existence and cutoff can only be effectively tested at period end since the risk may be greater at the end of the reporting period.

Account Considerations. The characteristics of the accounts need to be considered in deciding whether and when it is practical to audit an area or assertion at an interim date. For some account assertions, it may be more effective and/or efficient to perform the substantive testing at period end. In many cases, especially when substantive analytical procedures will be applied for the remaining period, the accounts that are best suited to interim testing have predictable balances and consistent activity levels. This makes it easier to develop more precise estimates of ending balances. Also, the accounts need to be regularly analyzed and adjusted and subjected to appropriate cutoff procedures. It is inefficient to test an account before the client has attempted to accurately determine what the balance should be.

Financial Reporting System Considerations. The auditor also considers the financial reporting system when selecting audit areas for interim testing. The system for the area to be tested needs to be capable of generating sufficient reliable data to allow the auditor to apply the planned procedures.

Testing the Remaining Period. The auditor needs to perform sufficient tests of the remaining period to extend the conclusion from the interim date to the balance sheet date. Although the auditor is not required to test controls to have a reasonable basis for extending audit conclusions from an interim date to the period end, the auditor considers 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, the auditor performs tests of controls or performs substantive procedures as of the period end. If, on the other hand, the auditor decides that substantive tests of the remaining period will be sufficient, those tests may include—

a. Comparison or reconciliation of information regarding the balance at the interim date with corresponding information at the balance sheet date (and investigation of unusual amounts).

b. Analytical procedures and/or tests of details.

The auditor determines the specific procedures to be performed based on the assessed risk associated with the remaining period. Tests of details can be used instead of (or in addition to) analytical procedures as considered necessary to obtain sufficient audit evidence.

Evaluating Audit Results. As previously discussed, when interim audit procedures are performed, the auditor forms a conclusion at an interim date and then extends that conclusion to the balance sheet date. If interim procedures reveal misstatements, AU-C 330.24 indicates that the auditor should assess the risk of misstatement related to those classes of transactions or account balances. Depending on that assessment, the auditor may either (a) modify the nature, timing, or extent of tests of the remaining period or (b) reperform or extend the interim procedures at the balance sheet date. The assessment may be based on consideration of the following factors:

- The possible implications of the nature and cause of the misstatements detected at the interim date. For example, if interim procedures revealed that the cost of certain types of inventory items was recalculated incorrectly, the auditor may need to perform additional procedures to determine whether the errors are likely to exist at year end.

- The possible relationship to other areas of the audit. The nature and amount of misstatements detected in interim testing may lead the auditor to reconsider the original assessment of the risk of material misstatement.

- The correcting entries subsequently recorded by the client. If the misstatements that were detected at interim were corrected before year end, the auditor does not need to record an audit adjustment or audit difference for those misstatements. However, the auditor considers whether similar adjustments are required at year end, and adjustments or audit differences need to be recorded for uncorrected misstatements that remain in the account.

- The results of audit procedures relating to the remaining period, especially those that might provide evidence regarding possible misstatements. If planned procedures for the remaining period are sufficiently effective, no specific additional procedures may be necessary. However, additional procedures will normally be necessary if there is a significant risk of material misstatement of the year-end balance.

The Use of Audit Evidence from Prior Periods

The ability to use audit evidence from the performance of substantive procedures in a prior audit is highly restricted. AU-C 330.A59 notes that in most cases, audit evidence from a previous audit's substantive procedures provides little or no audit evidence for the current period. Prior evidence substantiating the purchase cost of a building or building addition is one example of an instance in which audit evidence obtained from the performance of substantive procedures in a prior period may be relevant in the current period. This example is the common audit approach to auditing property by substantiating the changes to the beginning balance—additions and retirements—to reach a conclusion about the ending balance. Before using audit evidence obtained from the performance of substantive procedures in a prior audit, the auditor considers whether the audit evidence and the related subject matter have fundamentally changed and performs audit procedures during the current period to establish the continuing relevance of the audit evidence. As a general matter, the auditor's knowledge and experience from performing substantive procedures in prior audits is helpful in identifying risks of material misstatement for audit planning purposes, but does not provide substantive assurance in the current audit other than in circumstances in which the audit approach assumes that the opening balance audited in the prior year is not materially misstated.

Responding to Fraud Risks

The auditor is responsible for designing and performing the audit to obtain reasonable assurance of detecting material misstatements, whether caused by error or fraud. The auditor is required to specifically identify and assess risks of material misstatement due to fraud and develop an appropriate response. Based on the auditor's assessment of fraud risks, he or she may alter the nature of procedures performed (that is, apply additional procedures designed to detect fraud), or alter the timing or extent of procedures performed. The auditor may also require more or different evidence to support material transactions or balances than would be the case if the auditor did not identify any specific fraud risks. In addition, auditors are required to perform certain specific procedures to address the risk of management override of controls, including examining journal entries and other adjustments, reviewing accounting estimates for bias, and evaluating the business rationale for significant unusual transactions.

Overall Responses. Auditors generally use overall responses to address fraud risks that are pervasive to the financial statements. Overall responses affect the audit strategy (that is, the way the audit is conducted). Because there is always at least one identified fraud risk (the risk of management override of controls), certain overall responses are required in every audit. Overall responses are discussed in detail in *PPC's Guide to Audit Risk Assessment*.

Specific Responses. Specific responses to fraud risks involve the nature, timing, and extent of auditing procedures. Specific responses at the account balance, transaction class, or financial statement assertion level will vary depending on the types and combinations of fraud risks identified and the account balances, classes of transactions, or assertions that may be affected. Responses may involve both substantive procedures and tests of controls. However, tests of controls alone will not reduce audit risk to an appropriately low level because of the risk that management may override controls; therefore, tests of controls alone are not sufficient to respond to fraud risks.

When responding to fraud risks, the auditor may need to modify the nature, timing, and extent of audit procedures in the following ways:

- The *nature* of audit procedures may be modified to obtain more reliable evidence (such as evidence from independent sources outside the entity or evidence from tests of details rather than analytical procedures) or additional corroboration.

- The *timing* of audit procedures may be modified to perform more substantive procedures at year-end (for example, if interim audit procedures are planned, but there are unusual incentives for management or the owner/manager to engage in fraudulent financial reporting). Alternatively, substantive tests of transactions throughout the year may be performed to respond to the risk of fraud initiated in an interim period.

- The *extent* of audit procedures may be modified through larger sample sizes or by performing analytical procedures at a more detailed level to achieve a higher degree of precision.

If inherent risk is assessed at high because of the presence of fraud risks, the auditor might decide to increase the extent of procedures (for example, by performing analytical procedures at a more detailed level, obtaining a higher percentage of coverage when performing scope testing, or increasing sample sizes). A more effective response, however, might be to modify the nature of audit procedures in the area of concern rather than the extent. Examples of specific responses affecting the nature, timing, and extent of procedures are included in Exhibit 2-15. Exhibit 2-16 provides an illustration of how the auditor might use a combination of overall and specific responses to address a risk of improper revenue recognition.

Exhibit 2-15

Examples of Specific Responses to Fraud Risks

Nature of Audit Procedures

- Obtain evidence from more independent sources.
- Perform more physical observation and inspection procedures.
- Contact major suppliers and customers orally.
- Send confirmation requests to a specific party in an organization.
- Seek more or different information.
- Use computer-assisted audit techniques to gather more extensive evidence or perform different types of tests, such as data mining to identify unusual items.
- Perform a different combination of substantive tests of details and analytical procedures.
- Interview personnel involved in areas where identified fraud risks exist to obtain their insights about the risk and whether or how controls address the risk.
- If the work of specialists is especially significant to the financial statements, engage another specialist or perform additional procedures on the assumptions, methods, and findings.
- Confirm with customers relevant contract terms, account activity during the period, and the absence of side agreements. (Consider confirming both orally and in writing.)
- Review quarter- and year-end adjusting entries in detail, and investigate those that are unusual in nature or amount.
- Investigate significant and unusual transactions, particularly those around year end, for sources of their funding and possibility of involvement of related parties.
- Test the completeness and accuracy of computer-generated records and transactions.
- Analyze how issues involving estimates and judgments affecting opening balances previously audited were resolved using hindsight.
- Test account or other reconciliations prepared by the client, including those prepared at interim dates.
- Test the effectiveness of controls over revenue transactions that are initiated, processed, and recorded electronically to determine whether there is reasonable assurance they occurred and are properly recorded.
- Inquire of sales and marketing personnel or in-house legal counsel about their knowledge of sales or shipments near period end, including existence of any unusual terms or conditions.
- Inquire of those outside management and the accounting department to corroborate that management has the ability and intent to complete plans relevant to the development of the estimate.
- Inquire of the senior officer in charge of purchasing about the terms of vendor allowances and rebates, including oral agreements.
- Observe goods being shipped or readied for shipment and returns awaiting processing at one or more locations at period end as part of testing sales and inventory.
- Apply additional procedures during inventory observation, such as more rigorously examining product contents or quality, or the way boxes are stacked.
- Apply additional procedures to inventory tags, count sheets, etc.
- Obtain a further understanding of and test controls over assets that are highly prone to misappropriation.

Timing of Audit Procedures

- Confirm receivables at year end rather than at interim.
- Perform certain procedures on a surprise or unannounced basis.
- Observe inventory at all locations at once.
- Request physical inventories to be taken at or near year end.
- Apply substantive procedures to transactions occurring throughout the period under audit.

Extent of Audit Procedures

- Increase sample sizes.
- Obtain a higher percentage of coverage when performing scope testing, for example, by reducing the scope for detail tests of expense accounts.
- Observe inventory at special locations or all locations.
- When using the work of other auditors, discuss with them the extent of work needed to address identified fraud risks resulting from transactions and activities involving the two entities or components.

- Additional testing of inventory tags, count sheets, etc.
- Perform substantive analytical procedures, including the development of an expected dollar amount, using disaggregated data to achieve a high level of precision. (For example, compare monthly sales, cost of sales, and gross profit by location, line of business, or month to auditor-developed expected amounts.)
- Use computer-assisted audit techniques to test an entire population instead of a sample.

* * *

Exhibit 2-16

Use of Overall and Specific Responses in Combination

Identified Fraud Risk: Improper revenue recognition

Type of Response	Audit Response
Overall	Assign more experienced staff to perform the appropriate revenue procedures.
Specific	Perform all accounts receivable confirmation procedures at year-end.
Specific	Increase the extent of testing of subsequent account write-offs, returns, and collections.
Specific	Test the application of cash receipts to specific invoices in addition to confirmation.

* * *

Professional Skepticism. When gathering and evaluating audit evidence in response to identified fraud risks, auditors need to maintain an appropriate degree of professional skepticism. Examples of applying professional skepticism in response to risks of material misstatement due to fraud include:

- An increased recognition of the need to corroborate client explanations or representations (for example, through further analytical procedures, third-party confirmation, examination of independent documentation, or discussions with others within or outside the entity).

- Performing additional or different auditing procedures to obtain more reliable evidence in support of the auditor's objectives.

Considering the Results of Audit Procedures

The auditor's assessment of the risks of material misstatement at the relevant assertion level made during planning is based on available audit evidence and naturally may change as additional audit evidence is obtained. For example, in performing substantive procedures, the auditor may identify misstatements that are larger or more frequent than had been anticipated. Auditing standards provide the following requirements when audit evidence obtained during the audit is inconsistent with the original risk assessment:

- AU-C 315.32 requires the auditor to revise the risk assessment and modify further planned audit procedures if new information is obtained from performing further audit procedures or if the initial assessed risks of material misstatement at the assertion level changes during the audit.

- AU-C 500.10 requires the auditor to determine what modifications or additions to audit procedures are necessary and consider the effect on other aspects of the audit when audit evidence from one source is inconsistent with evidence from another source or there are doubts about the reliability of audit evidence.

- AU-C 520.07 requires the auditor to make and corroborate inquiries of management and perform other audit procedures as necessary when analytical procedures identify fluctuations or relationships that are inconsistent with other information or that differ from expected values by a significant amount.

Documentation

AU-C 330.30 and AU-C 240.44 require the auditor to document the following items relating to substantive procedures, including responses to fraud risks:

- The nature, timing, and extent of substantive procedures.
- The linkage of those procedures with the assessed risks at the relevant assertion level.
- The results of the procedures, including procedures to address the risk of management override of controls.

When substantive analytical procedures have been performed, the auditor should document (AU-C 520.08):

- the expectation and the factors used in its development (unless readily determinable from the work performed),
- the results of comparing recorded amounts or ratios developed from recorded amounts to the expectation, and
- any additional procedures performed to address significant unexplained differences, and the results of those procedures (for example, the amount of any misstatement quantified as a result of the analytical procedures performed).

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

20. Which of the following auditors has correctly addressed an issue related to substantive procedures?

    a. Ivan assesses risk of material misstatement for a relevant assertion as low, so he does not perform substantive procedures on it.

    b. Julie determines which substantive procedures she will perform using audit judgment and ends up performing different ones for each assertion.

    c. Keith uses only substantive analytical procedures to gather appropriate audit evidence for significant risks.

    d. Lana performs general procedures that relate to the engagement as a whole and not specific account balances.

21. Which of the following pieces of audit evidence is the most reliable?

    a. Item 1 was obtained by an employee of the entity under audit.

    b. Item 2 was obtained via inquiry.

    c. Item 3 was documented by the entity.

    d. Item 4 is a photocopy.

22. Which of the following auditors has changed the *extent* of his or her substantive procedures?

    a. Molly changes some of her originally selected procedures for more persuasive ones.

    b. Ned performs more procedures at the balance-sheet date instead of at an interim date.

    c. Olivia considers whether a misstatement was caused by error or fraud.

    d. Paul tests more items than he originally planned, focusing on those prone to misstatement.

23. Substantive analytical procedures alone would be most appropriate in which of the following situations?

    a. Risk of material misstatement due to fraud is high.

    b. The account balance has a small number of unusual transactions.

    c. Assertions about rights or obligations are being tested.

    d. The transaction class is unaffected by a significant amount of subjectivity.

24. Substantive tests of details would be more effective under what circumstances?

    a. A valuation assertion and in an unstable environment.

    b. An assertion about the completeness of assets.

    c. An assertion about the occurrence of revenues.

    d. An assertion about the occurrence of certain expenses.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

20. Which of the following auditors has correctly addressed an issue related to substantive procedures? **(Page 113)**

    a. Ivan assesses risk of material misstatement for a relevant assertion as low, so he does not perform substantive procedures on it. [This answer is incorrect. According to AU-C 330.18, no matter what the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions for each material class of transactions, account balance, and disclosure. Therefore, Ivan will still be required to perform some substantive procedures for this assertion.]

    b. Julie determines which substantive procedures she will perform using audit judgment and ends up performing different ones for each assertion. [This answer is incorrect. Certain substantive procedures should be performed in every audit. The additional substantive procedures that are needed in particular circumstances depend on the auditor's judgment about the sufficiency and appropriateness of audit evidence in the circumstances. Therefore, while many of Julie's procedures may be different, there are still certain particular ones that she will need to perform every time.]

    c. Keith uses only substantive analytical procedures to gather appropriate audit evidence for significant risks. [This answer is incorrect. When the audit approach to significant risks consists of only substantive procedures (that is, the auditor does not plan to rely on controls), the substantive procedures should be tests of details only or a combination of tests of details and substantive analytical procedures. The use of only substantive analytical procedures is not permitted, according to AU-C 330.22. Therefore, Keith's approach is not in conformity with the authoritative guidance.]

    d. Lana performs general procedures that relate to the engagement as a whole and not specific account balances. [This answer is correct. There are specific requirements to perform procedures, typically called *general procedures,* that do not related to particular account balances, such as performing a review for subsequent events and reading minutes of meetings of directors. Therefore, Lana has met these requirements in this scenario.]

21. Which of the following pieces of audit evidence is the most reliable? **(Page 114)**

    a. Item 1 was obtained by an employee of the entity under audit. [This answer is incorrect. According to AU-C 500.A32, audit evidence is more reliable when it is obtained from knowledgeable independent sources outside the entity.]

    b. Item 2 was obtained via inquiry. [This answer is incorrect. Per AU-C 500.A32, audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference.]

    c. Item 3 was documented by the entity. [This answer is correct. Audit evidence is more reliable when it exists in documentary form, whether paper, electronic, or other medium, per AU-C 500.A32.]

    d. Item 4 is an electronic image. [This answer is incorrect. Audit evidence provided by original documents, according to AU-C 500.A32, is more reliable than audit evidence provided by photocopies, faxes, or electronic images.]

22. Which of the following auditors has changed the *extent* of his or her substantive procedures? **(Page 117)**

    a. Molly changes some of her originally selected procedures for more persuasive ones. [This answer is incorrect. Molly has changed the *nature* of her procedures, not the extent.]

    b. Ned performs more procedures at the balance-sheet date instead of at an interim date. [This answer is incorrect. Ned has changed the *timing* of his procedures, not the extent.]

c. Olivia considers whether a misstatement was caused by error or fraud. [This answer is incorrect. The auditor considers whether the likely cause of misstatements (error, fraudulent financial reporting, or theft) will tend to result in understatement or overstatement of the account balance and designed procedures accordingly. However, an auditor's consideration of the nature of identified risks is separate from extending the nature, extent, or timing of substantive procedures to increase assurance.]

d. Paul tests more items than he originally planned, focusing on those prone to misstatement. [This answer is correct. Increasing the extent of tests can help an auditor increase the degree of assurance. This can be done by testing more items, changing the design of the test to focus on more items that are prone to misstatement, or increasing the precision of analytical procedures.]

23. Substantive analytical procedures alone would be most appropriate in which of the following situations? **(Page 118)**

a. Risk of material misstatement due to fraud is high. [This answer is incorrect. Substantive analytical procedures alone are more appropriate when the risks of material misstatement, including particular risks due to fraud, are relatively low.]

b. The account balance has a small number of unusual transactions. [This answer is incorrect. Substantive procedures alone will be more effective when the account balance, transaction class, or disclosure relates to large volumes of transactions that tend to be predictable over time.]

c. Assertions about rights or obligations are being tested. [This answer is incorrect. Analytical procedures are generally not effective in testing assertions about rights or obligations or assertions related to presentation and disclosure because those assertions do not lend themselves to testing through comparisons with expectations. Therefore, analytical procedures would not be effective responses for risks related to matters such as parties to transactions lacking in economic substance or intentional ambiguity in financial statement disclosures.]

d. The transaction class is unaffected by a significant amount of subjectivity. [This answer is correct. Substantive procedures include tests of details, substantive analytical procedures, or a combination of both. Therefore, designing the nature of substantive procedures involves deciding between or combining the two. In some cases, substantive procedures might be limited to substantive analytical procedures. Substantive procedures alone are more likely to be appropriate under certain circumstances, including when the account balance, transaction class, or disclosure is *not* affected by a significant degree of subjectivity.]

24. Substantive tests of details would be more effective under what circumstances? **(Page 119)**

a. A valuation assertion and in an unstable environment. [This answer is correct. Substantive tests of details may be more effective for valuation assertions in an unstable environment. The ability to develop an expectation that approximates the recorded amount is greater when the environment is stable.]

b. An assertion about the completeness of assets. [This answer is incorrect. Analytical procedures are often equally or more effective than tests of details for assertions about the completeness of assets, liabilities, revenues, and expenses. When testing for completeness, misstatements would often not be apparent from inspecting detailed evidence in the accounting records.]

c. An assertion about the occurrence of revenues. [This answer is incorrect. Analytical procedures are often equally or more effective than tests of details for assertions about the occurrence of revenues. For example, comparing recorded sales with the amount expected, based on reliable record of units sold and average prices, especially if comparisons are made by product line, may be as likely to detect a material misstatement of assertions about the occurrence of revenues as inspecting supporting documentation for a sample of recorded sales. Analytical procedures are more reliable if they are based on reliable data produced outside the accounting system.]

d. An assertion about the occurrence of certain expenses. [This answer is incorrect. Analytical procedures are often equally or more effective than tests of details for assertions about the occurrence of certain expenses. For example, comparing recorded production labor costs with the amount expected, based on the number of people required for the volume sustained during the year, may be as likely to detect a material misstatement as looking at supporting documentation for a sample of recorded compensation expense.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Audit Risk Assessment—Assessing and Responding to Identified Risks, Further Audit Procedures, and Other Matters (GRATG171)

Testing Instructions

1. Following these instructions is an **EXAMINATION FOR CPE CREDIT** consisting of multiple choice questions. You may print and use the **EXAMINATION FOR CPE CREDIT ANSWER SHEET** to complete the examination. This course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of the course, the participant then answers the examination questions and records answers to the examination questions on either the printed **Examination for CPE Credit Answer Sheet** or by logging onto the Online Grading System. The **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation Form** for each course are located at the end of all course materials.

   ONLINE GRADING. Log onto our Online Grading Center at **cl.thomsonreuters.com/ogs** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam of $89 is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

   PRINT GRADING. If you prefer, you may email, mail, or fax your completed answer sheet, as described below ($89 for email or fax; $99 for regular mail). The answer sheets are found at the end of the course PDFs. Answer sheets may be printed from the PDFs; they can also be scanned for email grading, if desired. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number. You may submit your answer sheet for grading three times. After the third unsuccessful attempt, another payment is required to continue.

   You may submit your completed **Examination for CPE Credit Answer Sheet, Self-study Course Evaluation,** and payment via one of the following methods:

   - Email to: *CPLGrading@thomsonreuters.com*
   - Fax to: **(888) 286-9070**
   - Mail to:

     Thomson Reuters
     Tax & Accounting—Checkpoint Learning
     GRATG171 Self-study CPE
     36786 Treasury Center
     Chicago, IL 60694-6700

   Note: The answer sheet has four bubbles for each question. However, if there is an exam question with only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Each answer sheet sent for print grading must be accompanied by the appropriate payment ($89 for answer sheets sent by email or fax; $99 for answer sheets sent by regular mail). Discounts apply for three or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price

for grading all three is $254 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $320 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $378 (a 15% discount on all five courses). The 15% discount also applies if more than five courses are submitted at the same time by the same participant. The $10 charge for sending answer sheets in the regular mail is waived when a discount for multiple courses applies.

4. To receive CPE credit, completed answer sheets must be postmarked or entered into the Online Grading Center by **October 31, 2018**. CPE credit will be given for examination scores of 70% or higher.

5. When using our print grading services, only the **Examination for CPE Credit Answer Sheet** should be submitted. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 431-9025.

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Audit Risk Assessment—Assessing and Responding to Identified Risks, Further Audit Procedures, and Other Matters (GRATG171)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet. The answer sheet can be printed out from the back of this PDF or accessed by logging onto the Online Grading System.

1. Under what circumstances would performance materiality most likely be established at a higher rate?

   a. A large number of misstatements are expected.

   b. Management prefers not to make adjustments to the financial statements.

   c. Few of the client's accounts require significant estimates.

   d. An account has a large number of locations and subsidiaries.

2. When using the PPC approach, performance materiality is often calculated between what percentages?

   a. 0% and 25%.

   b. 25% and 50%.

   c. 50% and 75%.

   d. 75% and 100%.

3. Which of the following assertions relates to account balances?

   a. Occurrence.

   b. Valuation and allocation.

   c. Accuracy.

   d. Classification and understandability.

4. Logan is engaged to perform an audit engagement. As part of the engagement, he identifies a valuation assertion with a related currency translation that has a reasonable chance of being misstated. If misstated, it could cause the financial statements to be materially misstated. What has Logan identified?

   a. An assertion.

   b. An assertion related to transaction classes.

   c. An assertion related to presentation and disclosure.

   d. A relevant assertion.

5. An auditor is required to assess the risk of material misstatement at what two levels when designing and performing further audit procedures?

   a. The financial statement level and the relevant assertion level.

   b. The relevant assertion level and the individual transaction level.

   c. The financial statement level and the entity level.

   d. The individual transaction level and the entity level.

6. As part of her audit engagement, Nora accumulates information that will help her identify potential risks. Then she considers whether this information, either by itself or as a whole, indicates areas where the financial statements may be vulnerable to material misstatement. What is the correct term for the process Nora just performed?

   a. Synthesis.

   b. Evaluation of inherent risk.

   c. An audit approach.

   d. Tests of details.

7. Which of the following auditors has correctly addressed an aspect of the synthesis process?

   a. Alan attributes verifiable business risks with an equal risk of material misstatement to the financial statements.

   b. Bunny determines fraud is not probable if all three fraud conditions listed in AU-C 240 are not present.

   c. Craig automatically assumes that there is a risk of material misstatement due to fraud because of improper revenue recognition.

   d. Delia articulates her client's risks of material misstatement at the financial statement level.

8. Which of the following risks would be considered well articulated?

   a. Client A's inventory is highly liquid and its safeguarding controls are poor.

   b. Client B did not record year-end liabilities for employee benefits or wages.

   c. Client C has a new other asset account that is significant in amount.

   d. Client D has an overstatement of its sales balance due to improper cutoff.

9. Which of the following is the auditor **not** required to document?

   a. The risk assessment procedures that were performed.

   b. The synthesis process used by the auditor.

   c. The risks of material misstatement identified at both levels.

   d. The risks of material misstatement due to fraud.

10. The risk of material misstatement is made up of which two components?

    a. Inherent risk and control risk.

    b. Inherent risk and detection risk.

    c. Audit risk and control risk.

    d. Audit risk and detection risk.

11. What two components make up detection risk?

    a. Inherent risk and control risk.

    b. Inherent risk and substantive analytical procedures risk.

    c. Tests of details risk and control risk.

    d. Tests of details risk and substantive analytical procedures risk.

12. Which of the following auditors has correctly dealt with an issue related to assessing the risk of material misstatement at the assertion level?

    a. Erin assesses audit risk at the relevant assertion level as moderate and documents that judgment in her workpapers.

    b. Finn uses a mathematical calculation so that his documentation of the associated risk is a precise measurement rather than a subjective judgment.

    c. Greta treats her assessed risks as if they are all of equal importance so that she can give them all equal attention during the audit.

    d. Hal uses evidence he obtained during last year's audit as support for the operating effectiveness of controls related to a significant risk.

13. When determining which risks would be considered significant, the auditor places the most weight on which of the following types of risk?

    a. The risk of material misstatement.

    b. Inherent risk.

    c. Control risk.

    d. Detection risk.

14. As part of her audit engagement, Audrey is assessing the risks of material misstatement at the assertion level based on the information she has gathered. Audrey finds one risk that she deems significant. Which of the following should she do?

    a. Evaluate the design of her client's related controls and see if they were implemented.

    b. Ensure that her audit approach toward this risk does not involve reliance on controls.

    c. Review information gathered on related controls from last year's audit.

    d. Limit her audit response to this risk to substantive analytical procedures for accuracy.

15. Whammy Inc. uses IT to initiate orders when goods are purchased and delivered. This process is based on predetermined rules of what to order and in what quantities. The related accounts payable is paid based on decisions generated by the system which are initiated when receipt of goods and terms of payment are confirmed. Outside the IT system, there is no documentation of orders that were placed or goods that were received. This is an example of which of the following?

    a. A risk for which substantive procedures alone will not be sufficient.

    b. A risk that can be reduced using only substantive analytical procedures.

    c. A risk based on an unusual transaction.

    d. A risk evaluated using the formula RMM = IR × CR.

16. Which of the following factors may indicate that an audit area is significant?

    a. The account balance's relative materiality to the financial statements as a whole.

    b. A transaction class that is small compared to the entity's overall operations.

    c. How likely the account balance or transaction class is to have an error.

    d. Disclosures that are simple and easy to make accurately.

17. As part of preparing a detailed audit plan for her audit engagement, Valerie assesses inherent risk and finds the following things. Which one will increase the inherent risk in Valerie's engagement?

    a. Her client uses specific identification to calculate inventory as opposed to LIFO.

    b. Her client maintains more physical inventory and less cash.

    c. Her client has an account with more accounting estimates than routine transactions.

    d. Her client maintains a consistent amount of working capital.

18. When taking a top-down approach to assessing control risk, what would the auditor do first?

    a. Identify significant processes and transaction classes.

    b. Identify significant classes of transactions, account and disclosures in the financial statements.

    c. Identify controls that prevent, or detect and correct, material misstatements in relevant assertions.

    d. Test controls for operating effectiveness and reduce the control level of risk assessment.

19. Bryant is using one of the PPC audit approaches in his engagement. He primarily performs substantive analytics, but also performs some tests of details, as required by GAAS. Which approach did Bryant use?

    a. Limited procedures.

    b. Basic procedures.

    c. Basic plus extended procedures.

    d. Specified risk procedures.

20. Assuming that all other factors qualify, the specified risk approach is more likely to apply to which of the following businesses?

    a. Smile Time's accountant is new and has a little experience.

    b. Mac-2 is a large company with publicly traded stocks.

    c. Baker's Dozen has one known material weakness in internal control.

    d. Emerald Press has its audit procedures performed entirely at year end.

21. Tests of details and analytical procedures are used in which of the PPC audit approaches?

    a. Limited procedures.

    b. Basic procedures.

    c. Extended procedures.

    d. Specified risk procedures.

22. As part of his audit engagement, Tyrone inspects the documents and accounting records involved in his client's individual transactions. This would be classified as which of the following? (Pick the most specific answer.)

    a. Tests of details.

    b. Tests of transactions.

    c. Tests of balances.

    d. Analytical procedures.

23. In her audit engagement, Lucy plans to rely on the operating effectiveness of internal control when she designs substantive procedures. Which of the following will she need to perform?

    a. Tests of details.

    b. Tests of transactions.

    c. Tests of balances.

    d. Tests of controls.

24. Which of the following auditors can have an expectation of operating effectiveness?

    a. Ingrid is unable to obtain an understanding of specific controls due to lack of information.

    b. John evaluates the controls' design and determines that they can prevent misstatement in the relevant assertion.

    c. Kristin determines that, though the controls exist, her client is not using them regularly.

    d. Luke prefers to design substantive procedures without relying on his client's internal controls.

25. Based on a cost/benefit analysis, it would be more efficient for which of the following auditors to use tests of controls?

    a. Mark's planned substantive procedures cannot be altered based on the results of tests of controls.

    b. Natalie will need to expand her tests of controls to cover several additional complementary controls to obtain enough evidence.

    c. Oliver's client redesigned the internal controls that would be affected by the test.

    d. Penny can use the audit evidence obtained in future audits of this client.

26. When deciding which controls to test, the auditor should identify which of the following first?

    a. Significant classes of transactions, account balances, and disclosures.

    b. Significant transaction classes.

    c. Significant processes related to transactions.

    d. Specific controls related to relevant assertions.

27. Which of the following is an example of a *key control*?

    a. IT general controls.

    b. Segregation of duties.

    c. The control environment.

    d. Documentation of management supervision.

28. Which of the following would most likely be used in a test of controls for an audit client's segregation of duties?

    a. Inquiry and observation.

    b. Inspection of documents, reports, or electronic files.

    c. Walkthroughs.

    d. Reperformance of the activity.

29. Audit sampling would most likely be used for which of the following controls?

    a. Control 1 is applied on a transaction basis.

    b. Control 2 rarely operates.

    c. Control 3 operates at a high level.

    d. Control 4 is an automated application control with effective IT general controls.

30. IT controls related to many applications are considered which of the following?

    a. Application controls.

    b. Automated controls.

    c. General controls.

    d. User controls.

31. When evaluating the evidence about operating effectiveness, Laurel discovers a deviation from her audit client's prescribed procedures. How should she proceed?

    a. She should assess control risk as high.

    b. She should assume the deviation is an isolated occurrence.

    c. She should assume that the deviation is the result of human error.

    d. She should investigate further and evaluate controls as a group.

32. Kurt needs to test his client's controls related to management review and approval of accounts receivable allowances, other reserves, and estimates. What procedures will provide the strongest evidence in this area?

    a. Inquiry and observation.

    b. Inspection of client documents.

    c. Reperformance.

    d. Walkthroughs.

33. Which of the following statements best describes an aspect of the evaluation of tests of controls and the assessment of control risk?

    a. More persuasive audit evidence is needed when less effectiveness is placed upon a particular control.

    b. If the auditor obtains a thorough understanding of controls, it is sufficient to serve as the test of operating effectiveness, as well.

    c. The evaluation of entity-level controls is made independently of the auditor's assessment of control risk.

    d. Generally, less rigorous substantive audit procedures are needed when the assessed level of control risk for an assertion is low.

34. Substantive procedures are made up of which of the following?

    a. Substantive analytical procedures and tests of controls.

    b. Substantive analytical procedures and tests of details.

    c. Risk assessment procedures and tests of controls.

    d. Risk assessment procedures and tests of details.

35. What is the correct term for the measurement of audit evidence's quality (its relevance and reliability)?

    a. Sufficiency.

    b. Appropriateness.

    c. Nature.

    d. Extent.

36. Which of the following is the most important consideration when designing further audit procedures?

    a. Nature.

    b. Extent.

    c. Timing.

    d. Sufficiency.

37. Which of the following would be considered a *flexible timing procedure*?

    a. Confirming accounts receivable.

    b. Observing inventory.

    c. Price testing inventory.

    d. Testing transactions affecting revenues and expenses.

38. Under what circumstances would it be feasible for an auditor to perform interim audit procedures?

    a. Substantive procedures covering the remaining period cannot be restricted.

    b. Sufficient information will be available for testing between the interim period and the balance sheet date.

    c. The assessed risk of material misstatement for the engagement is high.

    d. The financial system has an inherent delay that may make getting the information difficult.

39. Which of the following auditors has changed the nature of audit procedures to respond to fraud risks?

    a. Quinn performs more inspections of her client's payroll process.

    b. Robert confirms receivables at year end instead of at an interim date.

    c. Sharon observes her client's inventory at a special location.

    d. Travis uses computer-assisted audit techniques on the entire population instead of selecting a sample.

40. Which of the following auditors has increased his or her professional skepticism in response to an identified fraud risk?

    a. Umberto documents the nature, timing, and extent of his substantive procedures.

    b. Vivian applies further analytical procedures to corroborate client representations.

    c. Wanda contacts her client's major suppliers orally.

    d. Xander uses audit evidence he gathered with substantive procedures in a prior audit.

GLOSSARY

Application controls: These apply to the processing of individual transaction applications (such as sales, accounts receivable, and inventory) and relate to the use of IT to initiate, authorize, record, process, and report transactions or other financial data.

Approach: The method used or steps taken in setting about a task, problem, etc.

Appropriateness: The measure of the *quality* of audit evidence, that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.

Assertions: Representations by management, explicit or otherwise, that are embodied in the financial statements as used by the auditor to consider the different types of potential misstatements that may occur.

Audit area: Related account balances, transaction classes, and disclosures.

Audit evidence: Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. It includes both information contained in the accounting records underlying the financial statements and other information.

Audit risk: The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.

Automated controls: A type of *application control* that is performed by IT.

Basic procedures: These include primarily substantive analytical procedures and certain tests of details, most of which are required by specific AU-C sections.

Control: This addresses the risk of what could go wrong in the process, and by doing so it either prevents, or detects and corrects, misstatements that could occur as a result of processing the transaction.

Control risk: The risk that a misstatement that could occur in an assertion about a class of transaction, account balance, or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

Detection risk: The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

Dual-purpose test: A test that provides substantive audit evidence about both the transaction and the control activity.

Expectation of operating effectiveness: The auditor's planned control risk assessment is less than high.

Extended procedures: These are specific types of substantive procedures including tests of details, tests of transactions, tests of balances, and analytical procedures.

Flexible timing substantive procedures: Those that can be applied at any time, including an interim date.

General controls: Policies and procedures that relate to many applications. They are directed at ensuring continued proper operation of information systems, thereby supporting the effective functioning of application controls.

General procedures: Procedures that do not relate to particular account balances, such as reading the minutes of meetings of directors.

Implementation: Controls exist and are being used.

Indirect controls: Controls that the controls to be tested depend on. Also called complementary controls.

Inherent risk: The susceptibility of an assertion about a class of transaction, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

Interim audit procedures: These are performed to arrive at a conclusion about an account balance as of an interim date. Additional procedures are then performed to extend the interim conclusion to the balance sheet date.

Key controls: Controls that are important in preventing, or detecting and correcting, material misstatements in the relevant assertions.

Limited procedures: These consist of performing preliminary analytics, other risk assessment procedures and final analytics only.

Operating effectiveness: How and by whom controls are applied and the means by which, and the consistency with which, the controls are applied.

Performance materiality: The amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level of the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. Materiality at the account balance or transaction class level.

Process: An action taken. For example, coding of an invoice by the accounts payable clerk and the subsequent input to the payable system.

Relevant assertion: An assertion that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated.

Risk of material misstatement: The risk that the financial statements are materially misstated prior to the audit. It consists of *inherent risk* and *control risk.*

Substantive procedures: Further audit procedures performed for the purpose of detecting material misstatement at the relevant assertion level.

Sufficiency: The measure of the quantity of audit evidence.

Synthesis: A mental process involving analysis of the information gathered to identify risks.

Tests of balances: Tests applied directly to the details of balances in general ledger accounts.

Tests of controls: Further audit procedures performed with the objective of obtaining audit evidence about the effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

Tests of transactions: Tests of the processing of individual transactions by inspection of the documents and accounting records involved in processing or reperforming client routines.

Tolerable misstatement: The application of performance materiality to a particular audit sampling procedure. Materiality at the test or procedure level, for a specific account balance or transaction class when that procedure or test is applied using audit sampling.

User controls: A type of *application control* that is performed by individuals.

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EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Audit Risk Assessment—Assessing and Responding to Identified Risks, Further Audit Procedures, and Other Matters (GRATG171)

Name: ____________________

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	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
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2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
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9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

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Course Acronym: GRATG171

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Please indicate your answers by filling in the appropriate circle as shown:
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