



## **IDENTIFYING AND RESPONDING TO THE RISK OF MATERIAL MISSTATEMENT**

**J. Michael Inzina, CPA, CGFM, CGMA**

### **ALTEC**

Audit Litigation, Training and Efficiency Consulting, Inc.

1401 Hudson Lane, Suite 201

Monroe, LA 71201

(318) 322-2870 (voice)

(318) 322-2871 (fax)

**[www.altec-usa.com](http://www.altec-usa.com)**



## ABOUT THE AUTHOR

**J. Michael Inzina, CPA, CGFM, CGMA** is founder and chief executive officer of Audit Litigation Training and Efficiency Consulting, Inc. (ALTEC), a consulting company serving public accounting firms and other accounting and auditing organizations on matters of audit efficiency, continuing education, litigation and ethics. He has over 35 years of public accounting experience, and remains a partner in the firm of Stagni & Company, LLC, whose practice is concentrated in government and nonprofits organizations. Mike holds a BBA in accounting from the University of Louisiana (Monroe), where he graduated summa cum laude in May 1976. He is a member of the American Institute of CPAs, Society of Louisiana CPAs, Government Finance Officers Association of Louisiana, and the Association of Government Accountants. Mike earned the CEA in governmental in 1990, was awarded the Certified Government Financial Manager (CGFM) designation in 1996 and the Chartered Global Management Accountant (CGMA) designation in 2012. He is a past chapter president and member of the Society of Louisiana CPAs Board of Directors and served two terms as chairman of the Governmental Positive Enforcement Program of the Louisiana State Board of CPAs. He has served on a number of committees of the Society of Louisiana CPAs, and currently serves on its Ethics Committee. Mike also served on the GASB Service Efforts and Accomplishments Task Force.

Mike has twice been a member of the AICPA Professional Ethics Executive Committee (1989-1992 and 2000-2003), and served on the Auditing Standards Board from 1997 to 2000. From 1986 to 1993, he also served as a member of AICPA Independence and Behavioral Standards Subcommittee, and as Subgroup Chairman of the Governmental Technical Standards Committee. During this time he conducted numerous investigations of complaints filed by federal, state and local agencies alleging substandard performance of audits of governmental and nonprofit entities, and represented the Professional Ethics Division at hearings of the Joint Regional Trial Board.

He contributed to the *Implementation Guide* for GASB Statement 34, AICPA Statement of Position 98-3, *Audits of States, Local Governments and Not-for-Profit Organizations Receiving Federal Awards*, revisions to the AICPA Audit and Accounting Guide, *Audits of State and Local Governmental Units*, the AICPA Practice Aid *Fraud Detection in a GAAS Audit*, revisions to the Louisiana Governmental Audit Guide and in drafting state legislation affecting governmental accounting and auditing requirements. He has served as technical consultant and instructor for the Louisiana Division of Administration (Office of Community Development) and as consultant to the Louisiana Department of Education. Mike frequently appears as moderator and panelist on the Accountants' CPE Network (ACPEN).

Mike has been named twelve times as an Outstanding Instructor by the American Institute of CPAs and several state societies, and received a Special Recognition Award from the Society of Louisiana CPAs Board of Directors for his contributions to continuing education in 1994. In addition, he was awarded the 2001 National Education and Training Award from the Association of Government Accountants and in 2009 was named national Beta Alpha Psi Business Information Professional of the Year.

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# **Identifying and Responding to the Risk of Material Misstatement**

**Author/Instructor: J. Michael Inzina, CPA, CGFM, CGMA**

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**Description:** This course focuses on the most common financial statement risk areas, and what auditors should do to properly address those risks. Topics covered include :

- Applicable risk assessment standards
- Cash and cash equivalents
- Revenues and receivables
- Investments
- Property and equipment
- Current liabilities
- Long-term debt and other obligations
- Equity
- The operating statement

**Experience/Prerequisites:** Minimum to advanced level.

**Who should attend:** Partners and managers responsible for planning and supervision of engagements, as well as staff persons conducting those engagements.

**Recommended CPE credit:** 8 hours

**Acronym:** IRRM

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## Introduction

What makes an effective auditor? Opinions on the subject may vary somewhat, but in the author's mind, it requires two abilities:

- The ability to identify the existence of a risk of material misstatement, and
- The ability to develop an appropriate response to that risk, to determine whether in fact, the risk has materialized and caused the financial statements to be materially misstated.

Noticeably, the ability to apply an audit procedure is not included above, for the simple reason that *anyone* who can follow instructions can apply an audit procedure. However, if the procedure applied by that person is not appropriate to a specific risk, that procedure will never be effective, no matter how diligently it is applied. Someone must first determine what risks exist and then formulate a response that would be effective in bringing any misstatement to the auditor's attention.

Those of us who were practicing prior to the effective date of the risk assessment standards (December 31, 2007 and later audits) remember all too well the procedure-based audit. Essentially, auditors went to the field, applied a specified set of procedures, and if nothing came to the auditors' attention, drafted and issued the reports and sent the bill. Little attention was paid to facts and circumstances:

*“Just go out there and do what we did last year.”*

As evidence of that, consider the fact that under the procedure-based approach, audit programs were *rarely* modified from one period to the next, absent a change in the standards. Exactly the reason the risk assessment standards were adopted – to increase the likelihood that auditors would discover misstatements, whether caused by fraud or error. The risk assessment standards were simply an attempt to make audits more effective. It is, without question, a more precise, more reasoned approach. Risk-based auditing is about matching risks with resources – spending the time, applying the procedures, developing the documentation – all based on informed judgments about where risks of material misstatement exist in the financial statements and the circumstances that give rise to those risks.

Identification of the existence of a risk of material misstatement is based on the auditor's understanding of the entity under audit – the nature of its operations, the legal and regulatory environment in which it operates, the types of transactions it carries out, its operating policies and procedures, its personnel – the whole nine yards. This is what makes *information gathering* crucial to effective audit performance. That is why information gathering is the first step in the audit process – to provide the auditor with an adequate understanding of the facts and circumstances relevant to the entity.

Developing an appropriate response to risk requires critical thinking about what information the auditor can obtain to provide reasonable assurance about whether the risks identified *have* or *have not* caused a material misstatement to occur. Risks, of course, are first identified at the *financial statement* level. Responses, however, are carried out at the *assertion* level. Thus, developing a response is the process of considering “What could go wrong?” in terms of the assertions of management that are inherent in financial statements, and “What should I do to determine whether it has gone wrong?”

This material is designed to address both aspects of audit effectiveness, relating them to the assertions of management, as those assertions relate to the various elements of financial statements.

## Chapter 1

# Applicable AICPA Standards<sup>1</sup>

### AU-C Section 315 - Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement<sup>2</sup>

#### Scope of This Section

This section addresses the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements through understanding the entity and its environment, including the entity's internal control.

#### Objective

The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

#### Definitions (selected)

- **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.
- **Business risk.** A risk resulting from significant conditions, events, circumstances, actions, or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies or from the setting of inappropriate objectives and strategies.
- **Internal control.** A process effected by those charged with governance, management, and other personnel that is designed to provide reasonable assurance about the achievement of the entity's objectives with regard to the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to financial reporting and operations objectives.
- **Relevant assertion.** A financial statement assertion that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements

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<sup>1</sup> Requirements are presented in **bold type**; application guidance is presented in normal type.

<sup>2</sup> Only the portions of AU-C 315 relevant to identifying and assessing risk have been included; the portions related to internal control are omitted, but will be addressed in summary in Chapter 2.



to be materially misstated. The determination of whether an assertion is a relevant assertion is made without regard to the effect of internal controls.

- **Risk assessment procedures.** The audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels.
- **Significant risk.** An identified and assessed risk of material misstatement that, in the auditor's professional judgment, requires special audit consideration.

### Requirements and related application guidance

**The auditor should perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and relevant assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion.**

Obtaining an understanding of the entity and its environment, including the entity's internal control (referred to hereafter as an *understanding of the entity*), is a continuous, dynamic process of gathering, updating, and analyzing information throughout the audit. The understanding of the entity establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit when, for example:

- Assessing risks of material misstatement of the financial statements;
- Determining materiality in accordance with section 320, *Materiality in Planning and Performing an Audit*;
- Considering the appropriateness of the selection and application of accounting policies and the adequacy of financial statement disclosures;
- Identifying areas for which special audit consideration may be necessary (for example, related party transactions, the appropriateness of management's use of the going concern assumption, considering the business purpose of transactions, or the existence of complex and unusual transactions);
- Developing expectations for use when performing analytical procedures;
- Responding to the assessed risks of material misstatement, including designing and performing further audit procedures to obtain sufficient appropriate audit evidence; and
- Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and management's oral and written representations.

Information obtained by performing risk assessment procedures and related activities may be used by the auditor as audit evidence to support assessments of the risks of material misstatement. In addition, the auditor may obtain audit evidence about classes of transactions, account balances, or disclosures and relevant assertions and about the operating effectiveness

of controls, even though such procedures were not specifically planned as substantive procedures or tests of controls. The auditor also may choose to perform substantive procedures or tests of controls concurrently with risk assessment procedures because it is efficient to do so.

The auditor is required to exercise professional judgment to determine the extent of the required understanding of the entity. The auditor's primary consideration is whether the understanding of the entity that has been obtained is sufficient to meet the objective stated in this section. The depth of the overall understanding that is required by the auditor is less than that possessed by management in managing the entity.

The risks to be assessed include both those due to fraud and those due to error, and both are covered by this section. However, the significance of fraud is such that further requirements and guidance are included in section 240, *Consideration of Fraud in a Financial Statement Audit*, regarding risk assessment procedures and related activities to obtain information that is used to identify the risks of material misstatement due to fraud.

Although the auditor is required to perform all the risk assessment procedures in the course of obtaining the required understanding of the entity, the auditor is not required to perform all of them for each aspect of that understanding.

Other procedures may be performed when the information to be obtained therefrom may be helpful in identifying risks of material misstatement. Examples of such procedures include the following:

- Reviewing information obtained from external sources, such as trade and economic journals; reports by analysts, banks, or rating agencies; or regulatory or financial publications
- Making inquiries of the entity's external legal counsel or valuation specialists whom the entity has used

The risk assessment procedures should include the following:

- Inquiries of management and others within the entity who, in the auditor's professional judgment, may have information that is likely to assist in identifying risks of material misstatement due to fraud or error
- Analytical procedures
- Observation and inspection

Much of the information obtained by the auditor's inquiries is obtained from management and those responsible for financial reporting. However, the auditor also may obtain information or a different perspective in identifying risks of material misstatement through inquiries of others within the entity and other employees with different levels of authority. For example:

- Inquiries directed toward those charged with governance may help the auditor understand the environment in which the financial statements are prepared.
- Inquiries directed toward internal audit personnel may provide information about internal audit procedures performed during the year relating to the design and effectiveness of the entity's internal control and whether management has satisfactorily responded to findings from those procedures.
- Inquiries of employees involved in initiating, authorizing, processing, or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies.
- Inquiries directed toward in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements (such as joint ventures) with business partners, and the meaning of contract terms.
- Inquiries directed toward marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.

Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Analytical procedures performed as risk assessment procedures may include both financial and nonfinancial information (for example, the relationship between sales and square footage of selling space or volume of goods sold).

Analytical procedures may enhance the auditor's understanding of the client's business and the significant transactions and events that have occurred since the prior audit and also may help to identify the existence of unusual transactions or events and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures provide only a broad initial indication about whether a material misstatement may exist. Accordingly, in such cases, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures.

## **Considerations Specific to Smaller, Less Complex Entities**

Some smaller entities may not have interim or monthly financial information that can be used for purposes of analytical procedures. In these circumstances, although the auditor may be able to perform limited analytical procedures for purposes of planning the audit or obtain some information through inquiry, the auditor may need to plan to perform analytical procedures to identify and assess the risks of material misstatement when an early draft of the entity's financial statements is available.

Observation and inspection may support inquiries of management and others and also may provide information about the entity and its environment. Examples of such audit procedures include observation or inspection of the following:

- The entity's operations
- Documents (such as business plans and strategies), records, and internal control manuals
- Reports prepared by management (such as quarterly management reports and interim financial statements), those charged with governance (such as minutes of board of directors' meetings), and internal audit
- The entity's premises and plant facilities

**The auditor should consider whether information obtained from the auditor's client acceptance or continuance process is relevant to identifying risks of material misstatement.**

**If the engagement partner has performed other engagements for the entity, the engagement partner should consider whether information obtained is relevant to identifying risks of material misstatement.**

**During planning, the auditor should consider the results of the assessment of the risk of material misstatement due to fraud along with other information gathered in the process of identifying the risks of material misstatements.**

**When the auditor intends to use information obtained from the auditor's previous experience with the entity and from audit procedures performed in previous audits, the auditor should determine whether changes have occurred since the previous audit that may affect its relevance to the current audit.**

The auditor's previous experience with the entity and audit procedures performed in previous audits may provide the auditor with information about such matters as:

- Past misstatements and whether they were corrected on a timely basis.

- The nature of the entity and its environment and the entity's internal control (including deficiencies in internal control).
- Significant changes that the entity or its operations may have undergone since the prior financial period, which may assist the auditor in gaining a sufficient understanding of the entity to identify and assess risks of material misstatement.

The auditor is required to determine whether information obtained in prior periods remains relevant if the auditor intends to use that information for the purposes of the current audit. For example, changes in the control environment may affect the relevance of information obtained in the prior year. To determine whether changes have occurred that may affect the relevance of such information, the auditor may make inquiries and perform other appropriate audit procedures, such as walk-throughs of relevant systems.

**The engagement partner and other key engagement team members should discuss the susceptibility of the entity's financial statements to material misstatement and the application of the applicable financial reporting framework to the entity's facts and circumstances. The engagement partner should determine which matters are to be communicated to engagement team members not involved in the discussion.**

The discussion among the engagement team about the susceptibility of the entity's financial statements to material misstatement:

- Provides an opportunity for more experienced engagement team members, including the engagement partner, to share their insights based on their knowledge of the entity.
- Allows the engagement team members to exchange information about the business risks to which the entity is subject and about how and where the financial statements might be susceptible to material misstatement due to fraud or error.
- Assists the engagement team members to gain a better understanding of the potential for material misstatement of the financial statements in the specific areas assigned to them and to understand how the results of the audit procedures that they perform may affect other aspects of the audit, including the decisions about the nature, timing, and extent of further audit procedures.
- Provides a basis upon which engagement team members communicate and share new information obtained throughout the audit that may affect the assessment of risks of material misstatement or the audit procedures performed to address these risks.

This discussion may be held concurrently with the discussion among the engagement team that is required by Section 240 to discuss the susceptibility of the entity's financial statements to fraud. Section 240 further addresses the discussion among the engagement team about the risks of fraud.

It is not always necessary or practical for the discussion to include all members in a single discussion (as in group audits), nor is it necessary for all the members of the engagement team to be informed of all the decisions reached in the discussion. The engagement partner may

discuss matters with key members of the engagement team, including, if considered appropriate, those with specific skills or knowledge, and those responsible for the audits of components, while delegating discussion with others, taking account of the extent of communication considered necessary throughout the engagement team. A communications plan, agreed by the engagement partner, may be useful.

**Considerations Specific to Smaller, Less Complex Entities** Many small audits are carried out entirely by the engagement partner (who may be a sole practitioner). In such situations, it is the engagement partner who, having personally conducted the planning of the audit, would be responsible for *considering* the susceptibility of the entity's financial statements to material misstatement due to fraud or error.

**To provide a basis for designing and performing further audit procedures, the auditor should identify and assess the risks of material misstatement at:**

- **The financial statement level and**
- **The relevant assertion level for classes of transactions, account balances, and disclosures.**

Risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Rather, they represent circumstances that may increase the risks of material misstatement at the assertion level (for example, through management override of internal control). Financial statement level risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud.

**Risks at the financial statement level** may derive, in particular, from a deficient control environment (although these risks also may relate to factors such as declining economic conditions). For example, deficiencies such as management's lack of competence may have a more pervasive effect on the financial statements and may require an overall response by the auditor.

The auditor's understanding of internal control may raise doubts about the auditability of an entity's financial statements. For example:

- Concerns about the integrity of the entity's management may be so serious to cause the auditor to conclude that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted.
- Concerns about the condition and reliability of an entity's records may cause the auditor to conclude that it is unlikely that sufficient appropriate audit evidence will be available to support an unmodified opinion on the financial statements.

Section 705, *Modifications to the Opinion in the Independent Auditor's Report*, addresses the determination of whether a need exists for the auditor to express a qualified or adverse opinion or disclaim an opinion or, as may be required in some cases, to withdraw from the engagement when withdrawal is possible under applicable law or regulation.

**Risks of material misstatement at the relevant assertion level** for classes of transactions, account balances, and disclosures need to be considered because such consideration directly assists in determining the nature, timing, and extent of further audit procedures at the assertion level necessary to obtain sufficient appropriate audit evidence. In identifying and assessing risks of material misstatement at the relevant assertion level, the auditor may conclude that the identified risks relate more pervasively to the financial statements as a whole and potentially affect many relevant assertions.

**The Use of Assertions** In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation, and disclosure of the various elements of financial statements and related disclosures.

Assertions used by the auditor to consider the different types of potential misstatements that may occur fall into the following three categories and may take the following forms:

- Assertions about classes of transactions and events for the period under audit (the operating statement), such as the following:
  - *Occurrence*. Transactions and events that have been recorded have occurred and pertain to the entity.
  - *Completeness*. All transactions and events that should have been recorded have been recorded.
  - *Accuracy*. Amounts and other data relating to recorded transactions and events have been recorded appropriately.
  - *Cutoff*. Transactions and events have been recorded in the correct accounting period.
  - *Classification*. Transactions and events have been recorded in the proper accounts.
- Assertions about account balances at the period-end (the balance sheet), such as the following:
  - *Existence*. Assets, liabilities, and equity interests exist.
  - *Rights and obligations*. The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
  - *Completeness*. All assets, liabilities, and equity interests that should have been recorded have been recorded.
  - *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.

- Assertions about presentation and disclosure (the notes to financial statements), such as the following:
  - *Occurrence and rights and obligations*. Disclosed events, transactions, and other matters have occurred and pertain to the entity.
  - *Completeness*. All disclosures that should have been included in the financial statements have been included.
  - *Classification and understandability*. Financial information is appropriately presented and described, and disclosures are clearly expressed.
  - *Accuracy and valuation*. Financial and other information is disclosed fairly and in appropriate amounts.

The auditor may use the assertions as described previously or may express them differently, provided that all aspects described previously have been covered. For example, the auditor may choose to combine the assertions about transactions and events with the assertions about account balances. As another example, there may not be a separate assertion related to cutoff of transactions and events when the occurrence and completeness assertions include appropriate consideration of recording transactions in the correct accounting period.

**Relevant Assertions** The auditor is required to use relevant assertions for classes of transactions, account balances, and disclosures in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures. The auditor also is required to use relevant assertions in assessing risks by relating the identified risks to what can go wrong at the relevant assertion, taking account of relevant controls that the auditor intends to test, and designing further audit procedures that are responsive to the assessed risks.

*Relevant assertions* are assertions that have a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated and, as such, are assertions that have a meaningful bearing on whether the account is fairly stated. Not all assertions pertaining to a particular account balance will always be relevant. For example, valuation may not be relevant to the cash account unless currency translation is involved; however, existence and completeness are always relevant. Similarly, valuation may not be relevant to the gross amount of the accounts receivable balance but is relevant to the related allowance accounts. Additionally, the auditor might, in some circumstances, focus on the presentation and disclosure assertions separately in connection with the period-end financial reporting process.

For each significant class of transactions, account balance, and disclosure, the auditor is required to determine the relevance of each of the financial statement assertions. Identifying relevant assertions includes determining the source of likely potential misstatements in each significant class of transactions, account balance, and disclosure. Attributes indicating the potential relevance of an assertion include the:



- Nature of the assertion;
- Volume of transactions or data related to the assertion; and
- Nature and complexity of the systems, including the use of IT, by which the entity processes and controls information supporting the assertion.

**Considerations Specific to Governmental Entities** When making assertions about the financial statements of governmental entities, in addition to those assertions set out above, management asserts that transactions and events have been carried out in accordance with law or regulation. Such assertions may fall within the scope of the financial statement audit.

For this purpose, the auditor should:

- Identify risks throughout the process of obtaining an understanding of 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 the identified risks and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;
- Relate the identified risks to what can go wrong at the relevant assertion level, taking account of relevant controls that the auditor intends to test; and
- Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

Information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, is used as audit evidence to support the risk assessment. The risk assessment determines the nature, timing, and extent of further audit procedures to be performed.

Exhibit 1 (page 23) provides examples of conditions and events that may indicate the existence of risks of material misstatement.

**Relating Controls to Assertions** In making risk assessments, the auditor may identify the controls that are likely to prevent, or detect and correct, material misstatement in specific assertions. Generally, it is useful to obtain an understanding of controls and relate them to assertions in the context of processes and systems in which they exist because individual control activities often do not in themselves address a risk. Often, only multiple control activities, together with other components of internal control, will be sufficient to address a risk.

Conversely, some control activities may have a specific effect on an individual assertion embodied in a particular class of transactions or account balance. For example, the control activities that an entity established to ensure that its personnel are properly counting and recording the annual physical inventory relate directly to the existence and completeness assertions for the inventory account balance.

Controls can be either directly or indirectly related to an assertion. The more indirect the relationship, the less effective that control may be in preventing, or detecting and correcting, misstatements in that assertion. For example, a sales manager's review of a summary of sales activity for specific stores by region ordinarily is only indirectly related to the completeness assertion for sales revenue. Accordingly, it may be less effective in reducing risk for that assertion than controls more directly related to that assertion, such as matching shipping documents with billing documents.

**As part of the risk assessment described above, the auditor should determine whether any of the risks identified are, in the auditor's professional judgment, a significant risk. In exercising this judgment, the auditor should exclude the effects of identified controls related to the risk.**

**In exercising professional judgment about which risks are significant risks, the auditor should consider at least:**

- **Whether the risk is a risk of fraud;**
- **Whether the risk is related to recent significant economic, accounting, or other developments and, therefore, requires specific attention;**
- **The complexity of transactions;**
- **Whether the risk involves significant transactions with related parties;**
- **The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and**
- **Whether the risk involves significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual.**

Significant risks often relate to significant nonroutine transactions and matters that require significant judgment. *Nonroutine transactions* are transactions that are unusual, either due to size or nature, and that, therefore, occur infrequently. Matters that require significant judgment may include the development of accounting estimates for which a significant measurement uncertainty exists. Routine, noncomplex transactions that are subject to systematic processing are less likely to give rise to significant risks.

Risks of material misstatement may be greater for significant nonroutine transactions arising from matters such as the following:

- Greater management intervention to specify the accounting treatment
- Greater manual intervention for data collection and processing
- Complex calculations or accounting principles
- The nature of nonroutine transactions, which may make it difficult for the entity to implement effective controls over the risks
- Related party transactions

Risks of material misstatement may be greater for matters that require significant judgment, such as the development of accounting estimates, arising from matters such as the following:

- Accounting principles for accounting estimates or revenue recognition may be subject to differing interpretation.
- Required judgment may be subjective or complex or it may require assumptions about the effects of future events (for example, judgment about fair value).

Section 330, discussed in the next portion of this chapter, describes the consequences for further audit procedures of identifying a risk as significant.

**Significant Risks Relating to the Risks of Material Misstatement Due to Fraud** Section 240 further addresses the identification and assessment of the risks of material misstatement due to fraud.

**If the auditor has determined that a significant risk exists, the auditor should obtain an understanding of the entity's controls, including control activities, relevant to that risk and, based on that understanding, evaluate whether such controls have been suitably designed and implemented to mitigate such risks.**

Although risks relating to significant nonroutine transactions or matters that require significant judgment are often less likely to be subject to routine controls, management may have other responses intended to deal with such risks. Accordingly, the auditor's understanding of whether the entity has designed and implemented controls for significant risks arising from nonroutine transactions or matters that require significant judgment includes whether and how management responds to the risks. Such responses might include:

- Control activities, such as a review of assumptions by senior management or specialists.
- Documented processes for estimations.
- Approval by those charged with governance.

For example, when nonrecurring events occur, such as the receipt of notice of a significant lawsuit, consideration of the entity's response may include such matters as whether it has been referred to appropriate specialists (for example, internal or external legal counsel), whether an assessment has been made of the potential effect, and how it is proposed that the circumstances are to be disclosed in the financial statements.

In some cases, management may not have appropriately responded to significant risks of material misstatement by implementing controls over these significant risks. Failure by management to implement such controls may be a significant deficiency or a material weakness. In these circumstances, the auditor also may consider the implications for the auditor's risk assessment.

**In respect of some risks, the auditor may judge that it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures. Such risks may relate to the inaccurate or incomplete recording of routine and significant classes of transactions or account balances, the characteristics of which often permit highly automated processing with little or no manual intervention. In such cases, the entity's controls over such risks are relevant to the audit, and the auditor should obtain an understanding of them.**

Risks of material misstatement may relate directly to the recording of routine classes of transactions or account balances and the preparation of reliable financial statements. Such risks may include risks of inaccurate or incomplete processing for routine and significant classes of transactions, such as an entity's revenue; purchases; and cash receipts or cash payments.

When such routine business transactions are subject to highly automated processing with little or no manual intervention, it may not be possible to perform only substantive procedures regarding the risk. For example, the auditor may consider this to be the case when a significant amount of an entity's information is initiated, authorized, recorded, processed, or reported only in electronic form, such as in an integrated system. In such cases:

- Audit evidence may be available only in electronic form, and its sufficiency and appropriateness usually depend on the effectiveness of controls over its accuracy and completeness.
- The potential for improper initiation or alteration of information to occur and not be detected may be greater if appropriate controls are not operating effectively.

Examples of situations in which the auditor may find it impossible to design effective substantive procedures that, by themselves, provide sufficient appropriate audit evidence that certain relevant assertions are not materially misstated include the following:

- 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 system-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.
- 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, initiate and process its billings for the services, and automatically record such amounts in electronic accounting records that are part of the system used to produce the entity's financial statements.

The consequences for further audit procedures of identifying such risks are described in section 330.

**The auditor's assessment of the risks of material misstatement at the assertion level may change during the course of the audit as additional audit evidence is obtained. In circumstances in which 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, the auditor should revise the assessment and modify the further planned audit procedures accordingly.**

During the audit, information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based. For example, the risk assessment may be based on an expectation that controls are operating effectively. In performing tests of controls, the auditor may obtain audit evidence that they were not operating effectively at relevant times during the audit. Similarly, in performing substantive procedures, the auditor may detect misstatements in amounts or frequency greater than is consistent with the auditor's risk assessment. In such circumstances, the risk assessment may not appropriately reflect the true circumstances of the entity, and the further planned audit procedures may not be effective in detecting material misstatements. See section 330 for further guidance.

## **Documentation**

**The auditor should include in the audit documentation the:**

- **Discussion among the engagement team, the significant decisions reached, how and when the discussion occurred, and the audit team members who participated;**
- **Key elements of the understanding obtained regarding each of the aspects of the entity and its environment and each of the internal control components, the sources of information from which the understanding was obtained, and the risk assessment procedures performed;**
- **Identified and assessed risks of material misstatement at the financial statement level and at the relevant assertion level and**
- **Risks identified and related controls about which the auditor has obtained an understanding**

The manner in which the requirements are documented is for the auditor to determine exercising professional judgment. For example, in audits of smaller entities, the documentation may be incorporated in the auditor's documentation of the overall strategy and audit plan. Similarly, the results of the risk assessment may be documented separately, or they may be documented as part of the auditor's documentation of further audit procedures. The form and extent of the documentation is influenced by the nature, size, and complexity of the entity and its internal control; availability of information from the entity; and the audit methodology and technology used in the course of the audit.

For entities that have uncomplicated businesses and processes relevant to financial reporting, the documentation may be simple and relatively brief. It is not necessary to document the entirety of the auditor's understanding of the entity and matters related to it. Key elements of the understanding documented by the auditor include those on which the auditor based the assessment of the risks of material misstatement.

The extent of documentation also may reflect the experience and capabilities of the members of the audit engagement team. Provided that the requirements of section 230, *Audit Documentation*, are met, an audit undertaken by an engagement team comprising less experienced individuals may contain more detailed documentation to assist them to obtain an appropriate understanding of the entity than one that includes experienced individuals.

For recurring audits, certain documentation may be carried forward and updated as necessary to reflect changes in the entity's business or processes.

## **Exhibit 1**

### **Conditions and Events That May Indicate Risks of Material Misstatement**

The following are examples of conditions and events that may indicate the existence of risks of material misstatement. The examples provided cover a broad range of conditions and events; however, not all conditions and events are relevant to every audit engagement, and the list of examples is not necessarily complete.

- Operations in regions that are economically unstable (for example, countries with significant currency devaluation or highly inflationary economies)
- Operations exposed to volatile markets (for example, futures trading)
- Operations that are subject to a high degree of complex regulation
- Going concern and liquidity issues, including loss of significant customers
- Constraints on the availability of capital and credit
- Changes in the industry in which the entity operates
- Changes in the supply chain
- Developing or offering new products or services or moving into new lines of business
- Expanding into new locations
- Changes in the entity, such as large acquisitions or reorganizations or other unusual events
- Entities or business segments likely to be sold
- The existence of complex alliances and joint ventures
- Use of off balance sheet finance, investments in entities formed to accomplish specific objectives, and other complex financing arrangements
- Significant transactions with related parties
- Lack of personnel with appropriate accounting and financial reporting skills
- Changes in key personnel, including departure of key executives
- Deficiencies in internal control, especially those not addressed by management
- Inconsistencies between the entity's IT strategy and its business strategies
- Inquiries into the entity's operations or financial results by regulatory or government bodies
- Past misstatements, history of errors, or a significant amount of adjustments at period-end
- Significant amount of nonroutine or nonsystematic transactions, including intercompany transactions and large revenue transactions at period-end
- Transactions that are recorded based on management's intent (for example, debt refinancing, assets to be sold, and classification of marketable securities)
- Application of new accounting pronouncements
- Accounting measurements that involve complex processes
- Events or transactions that involve significant measurement uncertainty, including accounting estimates
- Pending litigation and contingent liabilities (for example, sales warranties, financial guarantees, and environmental remediation)

## **AU-C 330 - Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained**

This section addresses the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, and to evaluate the audit evidence obtained in an audit of financial statements.

### **Objective**

The objective of the auditor is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement through designing and implementing appropriate responses to those risks.

### **Definitions**

For purposes of generally accepted auditing standards, the following terms have the meanings attributed as follows:

- **Substantive procedure.** An audit procedure designed to detect material misstatements at the assertion level. Substantive procedures include:
  - Tests of details (classes of transactions, account balances, and disclosures) and
  - Substantive analytical procedures.
- **Test of controls.** An audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

### **Requirements** and related application guidance

**The auditor should design and implement overall responses to address the assessed risks of material misstatement at the financial statement level.**

Overall responses to address the assessed risks of material misstatement at the financial statement level may include:

- Emphasizing to the audit team the need to maintain professional skepticism.
- Assigning more experienced staff or those with specialized skills or using specialists.
- Providing more supervision.



- Incorporating additional elements of unpredictability in the selection of further audit procedures to be performed.
- Making general changes to the nature, timing, or extent of audit procedures (for example, performing substantive procedures at period-end instead of at an interim date or modifying the nature of audit procedures to obtain more persuasive audit evidence).

The assessment of the risks of material misstatement at the financial statement level and, thereby, the auditor's overall responses are affected by the auditor's understanding of the control environment. An effective control environment may allow the auditor to have more confidence in internal control and the reliability of audit evidence generated internally within the entity and, thus, for example, allow the auditor to conduct some audit procedures at an interim date rather than at the period-end. Deficiencies in the control environment, however, have the opposite effect. For example, the auditor may respond to an ineffective control environment by:

- Conducting more audit procedures as of the period-end rather than at an interim date,
- Obtaining more extensive audit evidence from substantive procedures, and
- Increasing the number of locations to be included in the audit scope.

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

**The auditor should design and perform further audit procedures whose nature, timing, and extent are based on, and are responsive to, the assessed risks of material misstatement at the relevant assertion level.**

The auditor's assessment of the identified risks at the relevant assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit procedures. For example, the auditor may determine that:

- In addition to the substantive procedures that are required for all relevant assertions, an effective response to the assessed risk of material misstatement for a particular assertion can be achieved only by also performing tests of controls.
- Performing only substantive procedures is appropriate for particular assertions, and therefore, the auditor excludes the effect of controls from the relevant risk assessment. This may be because the auditor's risk assessment procedures have not identified any effective controls relevant to the assertion or because testing controls would be inefficient, and therefore, the auditor does not intend to rely on the operating effectiveness of controls in determining the nature, timing, and extent of substantive procedures.
- A combined approach using both tests of controls and substantive procedures is an effective approach.

The *nature* of an audit procedure refers to its purpose (test of controls or substantive procedure) and its type (inspection, observation, inquiry, confirmation, recalculation, reperformance, or analytical procedure). The nature of the audit procedures is most important in responding to the assessed risks.

*Timing* of an audit procedure refers to when it is performed or the period or date to which the audit evidence applies.

*Extent* of an audit procedure refers to the quantity to be performed (for example, a sample size or the number of observations of a control activity).

Designing and performing further audit procedures whose nature, timing, and extent are based on, and are responsive to, the assessed risks of material misstatement at the relevant assertion level provides a clear *linkage* between the auditor's further audit procedures and the risk assessment.

Because effective internal controls generally reduce but do not eliminate the risk of material misstatement, tests of controls reduce but do not eliminate the need for substantive procedures. In addition, analytical procedures alone may not be sufficient in some cases. For example, when auditing certain estimation processes, such as the allowance for doubtful accounts, the auditor may perform substantive procedures beyond analytical procedures (for example, examining cash collections subsequent to the period-end) due to the risk of management override of controls or the subjectivity of the account balance.

**In designing the further audit procedures to be performed, the auditor should:**

- **Consider the reasons for the assessed risk of material misstatement at the relevant assertion level for each class of transactions, account balance, and disclosure, including:**
  - **The likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (the inherent risk) and**
  - **Whether the risk assessment takes account of relevant controls (the control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing, and extent of substantive procedures), and**
- **Obtain more persuasive audit evidence the higher the auditor's assessment of risk.**

**Nature** The auditor's assessed risks may affect both the types of audit procedures to be performed and their combination. For example, when an assessed risk is high, the auditor may confirm the completeness of the terms of a contract with the counterparty, in addition to inspecting the document. Further, certain audit procedures may be more appropriate for some assertions than others. For example, regarding revenue, tests of controls may be most responsive to the assessed risk of misstatement of the completeness assertion, whereas substantive procedures may be most responsive to the assessed risk of misstatement of the occurrence assertion.

The reasons for the assessment given to a risk are relevant in determining the nature of audit procedures. For example, if an assessed risk is lower because of the particular characteristics of a class of transactions without consideration of the related controls, then the auditor may determine that substantive analytical procedures alone provide sufficient appropriate audit evidence. On the other hand, if the assessed risk is lower because of internal controls and the auditor intends to base the substantive procedures on that low assessment, then the auditor performs tests of those controls. This may be the case, for example, for a class of transactions of reasonably uniform, noncomplex characteristics that are routinely processed and controlled by the entity's information system.

**Timing** The auditor may perform tests of controls or substantive procedures at an interim date or at the period-end. The higher the risk of material misstatement, the more likely it is that the auditor may decide it is more effective to perform substantive procedures nearer to or at the period-end rather than at an earlier date or to perform audit procedures unannounced or at unpredictable times (for example, performing audit procedures at selected locations on an unannounced basis). This is particularly relevant when considering the response to the risks of fraud. For example, the auditor may conclude that, when the risks of intentional misstatement or manipulation have been identified, audit procedures to extend audit conclusions from the interim date to the period-end would not be effective.

On the other hand, performing audit procedures before the period-end may assist the auditor in identifying significant issues at an early stage of the audit and consequently resolving them with the assistance of management or developing an effective audit approach to address such issues.

In addition, certain audit procedures can be performed only at or after the period-end. For example:

- Agreeing the financial statements to the accounting records,
- Examining adjustments made during the course of preparing the financial statements, and
- Procedures to respond to a risk that at the period-end the entity may have entered into improper sales contracts or transactions may not have been finalized.

Further relevant factors that influence the auditor's consideration of when to perform audit procedures include:

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

**Extent** The extent of an audit procedure judged necessary is determined after considering the materiality, assessed risk, and degree of assurance the auditor plans to obtain. When a single purpose is met by a combination of procedures, the extent of each procedure may be considered separately. In general, the extent of audit procedures increases as the risks of material misstatement increase. For example, in response to the assessed risks of material misstatement due to fraud, increasing sample sizes or performing substantive analytical procedures at a more detailed level may be appropriate. However, increasing the extent of an audit procedure is effective only if the audit procedure itself is relevant to the specific risk.

The use of computer assisted audit techniques (CAATs) may enable more extensive testing of electronic transactions and account files, which may be useful when the auditor decides to modify the extent of testing (for example, in responding to the risks of material misstatement due to fraud). Such techniques can be used to select sample transactions from key electronic files, sort transactions with specific characteristics, or test an entire population instead of a sample.

**Considerations Specific to Governmental Entities** For the audits of governmental entities, the audit mandate and any other special auditing requirements may affect the auditor's consideration of the nature, timing, and extent of further audit procedures. For example, under some governmental audit requirements, the auditor is required to perform tests of controls, even if reliance is not planned.

**Considerations Specific to Smaller, Less Complex Entities** In the case of smaller entities, the auditor may not identify control activities, or the extent to which their existence or operation have been documented by the entity may be limited. In such cases, it may be more efficient for the auditor to perform further audit procedures that are primarily substantive procedures. In some rare cases, however, the absence of control activities or other components of control may make it impossible to obtain sufficient appropriate audit evidence.

When obtaining more persuasive audit evidence because of a higher assessment of risk, the auditor may increase the quantity of the evidence or obtain evidence that is more relevant or reliable (for example by placing more emphasis on obtaining third party evidence or by obtaining corroborating evidence from a number of independent sources).

**The auditor should design and perform tests of controls to obtain sufficient appropriate audit evidence about the operating effectiveness of relevant controls if:**

- **The auditor's assessment of risks of material misstatement at the relevant assertion level includes an expectation that the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing, and extent of substantive procedures) or**
- **Substantive procedures alone cannot provide sufficient appropriate audit evidence at the relevant assertion level.**

Tests of controls are performed only on those controls that the auditor has determined are suitably designed to prevent, or detect and correct, a material misstatement in a relevant assertion. If substantially different controls were used at different times during the period under audit, each is considered separately.

Testing the operating effectiveness of controls is different from obtaining an understanding of and evaluating the design and implementation of controls. However, the same types of audit procedures are used. The auditor may, therefore, decide it is efficient to test the operating effectiveness of controls at the same time the auditor is evaluating their design and determining that they have been implemented.

Further, although some risk assessment procedures may not have been specifically designed as tests of controls, they may nevertheless provide audit evidence about the operating effectiveness of the controls and, consequently, serve as tests of controls. For example, the auditor's risk assessment procedures may have included the following:

- Inquiring about management's use of budgets
- Observing management's comparison of monthly budgeted and actual expenses
- Inspecting reports pertaining to the investigation of variances between budgeted and actual amounts

These audit procedures provide knowledge about the design of the entity's budgeting policies and whether they have been implemented but also may provide audit evidence about the effectiveness of the operation of budgeting policies in preventing, or detecting and correcting, material misstatements in the classification of expenses.

In addition, the auditor may design a test of controls to be performed concurrently with a test of details on the same transaction. Although the purpose of a test of controls is different from the purpose of a test of details, both may be accomplished concurrently by performing a test of controls and a test of details on the same transaction, which also is known as a *dual purpose test*. For example, the auditor may design and evaluate the results of a test to examine an invoice to determine whether it has been approved and to provide substantive audit

evidence of a transaction. A dual purpose test is designed and evaluated by considering each purpose of the test separately.

In some cases, the auditor may find it impossible to design effective substantive procedures that, by themselves, provide sufficient appropriate audit evidence at the relevant assertion level. This may occur when an entity conducts its business using IT and no documentation of transactions is produced or maintained, other than through the IT system. In such cases, the auditor is required to perform tests of relevant controls.

The auditor may consider testing the operating effectiveness of controls, if any, over the entity's preparation of information used by the auditor in performing substantive analytical procedures in response to assessed risks.

**In designing and performing tests of controls, the auditor should obtain more persuasive audit evidence the greater the reliance the auditor places on the effectiveness of a control.**

A higher level of assurance may be sought about the operating effectiveness of controls when the approach adopted consists primarily of tests of controls, in particular when it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures.

**In designing and performing tests of controls, the auditor should:**

- **Perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including:**
  - **How the controls were applied at relevant times during the period under audit;**
  - **The consistency with which they were applied; and**
  - **By whom or by what means they were applied, including, when applicable, whether the person performing the control possesses the necessary authority and competence to perform the control effectively, and**
- **Determine whether the controls to be tested depend upon other controls (indirect controls) and, if so, whether it is necessary to obtain audit evidence supporting the operating effectiveness of those indirect controls.**

Inquiry alone is not sufficient to test the operating effectiveness of controls. Accordingly, other audit procedures are performed in combination with inquiry. In this regard, inquiry combined with inspection, recalculation, or reperformance may provide more assurance than inquiry and observation because an observation is pertinent only at the point in time at which it is made.

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

In some situations, particularly in smaller, less complex entities, an entity might use a third party to provide assistance with certain financial reporting functions. When assessing the competence of personnel responsible for an entity's financial reporting and associated controls, the auditor may take into account the combined competence of entity personnel and other parties that assist with functions related to financial reporting.

When more persuasive audit evidence is needed regarding the effectiveness of a control, it may be appropriate to increase the extent of testing of the control. In addition to the degree of reliance on controls, matters the auditor may consider in determining the extent of tests of controls include the following:

- The frequency of the performance of the control by the entity during the period
- The length of time during the audit period that the auditor is relying on the operating effectiveness of the control
- The expected rate of deviation from a control
- The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control at the relevant assertion level
- The extent to which audit evidence is obtained from tests of other controls related to the relevant assertion

However, the rate of expected deviation may indicate that obtaining audit evidence from the performance of tests of controls will not be sufficient to reduce the control risk at the relevant assertion level. If the rate of expected deviation is expected to be high, tests of controls for a particular assertion may not provide sufficient appropriate audit evidence.

Because of the inherent consistency of IT processing, it may not be necessary to increase the extent of testing of an automated control. An automated control can be expected to function consistently unless the program (including the tables, files, or other permanent data used by the program) is changed. Once the auditor determines that an automated control is functioning as intended (which could be done at the time the control is initially implemented or at some other date), the auditor may consider performing tests to determine that the control continues to function effectively. Such tests might include determining that:

- Changes to the program are not made without being subject to the appropriate program change controls,
- The authorized version of the program is used for processing transactions, and
- Other relevant general controls are effective.

Such tests also might include determining that changes to the programs have not been made, which may be the case when the entity uses packaged software applications without modifying or maintaining them. For example, the auditor may inspect the record of the administration of IT security to obtain audit evidence that unauthorized access has not occurred during the period.

In some circumstances, it may be necessary to obtain audit evidence supporting the effective operation of indirect controls. For example, when the auditor decides to test the effectiveness of a user review of exception reports detailing sales in excess of authorized credit limits, the user review and related follow up is the control that is of direct relevance to the auditor. Controls over the accuracy of the information in the reports (for example, the general IT controls) are described as indirect controls.

Because of the inherent consistency of IT processing, audit evidence about the implementation of an automated application control, when considered in combination with audit evidence about the operating effectiveness of the entity's general IT controls (in particular, change controls), also may provide substantial audit evidence about its operating effectiveness.

**The auditor should test controls for the particular time or throughout the period for which the auditor intends to rely on those controls, subject to the paragraphs that follow, in order to provide an appropriate basis for the auditor's intended reliance.**

Audit evidence pertaining only to a point in time may be sufficient for the auditor's purpose (for example, when testing controls over the entity's physical inventory counting at the period-end). If, on the other hand, the auditor intends to rely on a control over a period, tests that are capable of providing audit evidence that the control operated effectively at relevant times during that period are appropriate. Such tests may include tests of the entity's monitoring of controls.



**If the auditor obtains audit evidence about the operating effectiveness of controls during an interim period, the auditor should:**

- **Obtain audit evidence about significant changes to those controls subsequent to the interim period and**
- **Determine the additional audit evidence to be obtained for the remaining period.**

Relevant factors in determining what additional audit evidence to obtain about controls that were operating during the period remaining after an interim period, include the following:

- The significance of the assessed risks of material misstatement at the relevant assertion level
- The specific controls that were tested during the interim period and the results of those tests
- Significant changes to the controls since they were tested, including changes in the information system, processes, and personnel
- The degree to which audit evidence about the operating effectiveness of those controls was obtained
- The length of the remaining period
- The extent to which the auditor intends to reduce further substantive procedures based on the reliance of controls
- The effectiveness of the control environment

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

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

- **The effectiveness of other elements of internal control, including the control environment, the entity's monitoring of controls, and the entity's risk assessment process;**
- **The risks arising from the characteristics of the control, including whether the control is manual or automated;**
- **The effectiveness of general IT controls;**
- **The effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control noted in previous audits and whether there have been personnel changes that significantly affect the application of the control;**
- **Whether the lack of a change in a particular control poses a risk due to changing circumstances; and**
- **The risks of material misstatement and the extent of reliance on the control.**

In certain circumstances, audit evidence obtained from previous audits may provide audit evidence, provided that the auditor has determined whether changes have occurred since the previous audit that may affect its relevance to the current audit. For example, in performing a previous audit, the auditor may have determined that an automated control was functioning as intended. The auditor may obtain audit evidence to determine whether changes to the automated control have been made that affect its continued effective functioning through, for example, inquiries of management and the inspection of logs to indicate what controls have been changed. Consideration of audit evidence about these changes may support either increasing or decreasing the expected audit evidence to be obtained in the current period about the operating effectiveness of the controls.

**If the auditor plans to use audit evidence from a previous audit about the operating effectiveness of specific controls, the auditor should perform audit procedures to establish the continuing relevance of that information to the current audit. The auditor should obtain this evidence by performing inquiry, combined with observation or inspection, to confirm the understanding of those specific controls, and:**

- **If there have been changes that affect the continuing relevance of the audit evidence from the previous audit, the auditor should test the controls in the current audit.**
- **If there have not been such changes, the auditor should test the controls at least once in every third audit and should test some controls during each audit to avoid the possibility of testing all the controls on which the auditor intends to rely in a single audit period with no testing of controls in the subsequent two audit periods.**

Changes may affect the relevance of the audit evidence obtained in previous audits such that there may no longer be a basis for continued reliance. For example, changes in a system that enable an entity to receive a new report from the system probably do not affect the relevance of audit evidence from a previous audit; however, a change that causes data to be accumulated or calculated differently does affect it.

The auditor's decision on whether to rely on audit evidence obtained in previous audits for controls that:

- Have not changed since they were last tested and
- Are not controls that mitigate a significant risk

is a matter of professional judgment. In addition, the length of time between retesting such controls is also a matter of professional judgment but is required to be at least once in every third audit. (This guidance may not be appropriate for audits not performed at least on an annual basis.)

In general, the higher the risk of material misstatement or the greater the reliance on controls, the shorter the time period elapsed, if any, is likely to be. Factors that may decrease the period

for retesting a control or result in not relying on audit evidence obtained in previous audits at all include the following:

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

When there are a number of controls for which the auditor intends to rely on audit evidence obtained in previous audits, testing some of those controls in each audit provides corroborating information about the continuing effectiveness of the control environment. This contributes to the auditor's decision about whether it is appropriate to rely on audit evidence obtained in previous audits.

**If the auditor plans to rely on controls over a risk the auditor has determined to be a significant risk, the auditor should test the operating effectiveness of those controls in the current period.**

**When evaluating the operating effectiveness of relevant controls, the auditor should evaluate whether misstatements that have been detected by substantive procedures indicate that controls are not operating effectively. The absence of misstatements detected by substantive procedures, however, does not provide audit evidence that controls related to the relevant assertion being tested are effective.**

The identification by the auditor of a material misstatement of the financial statements under audit in circumstances that indicate that the misstatement would not have been detected by the entity's internal control is an indicator of a material weakness.

**If deviations from controls upon which the auditor intends to rely are detected, the auditor should make specific inquiries to understand these matters and their potential consequences and should determine whether:**

- **The tests of controls that have been performed provide an appropriate basis for reliance on the controls,**
- **Additional tests of controls are necessary, or**
- **The potential risks of misstatement need to be addressed using substantive procedures.**

The concept of effectiveness of the operation of controls recognizes that some deviations in the way controls are applied by the entity may occur. Deviations from prescribed controls may be caused by such factors as changes in key personnel, significant seasonal fluctuations

in volume of transactions, and human error. The detected rate of deviation, in particular, in comparison with the expected rate, may indicate that the control cannot be relied on to reduce risk at the relevant assertion level to that assessed by the auditor.

**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, and disclosure.**

The auditor is required to design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure, irrespective of the assessed risks of material misstatement. This requirement reflects the facts that (i) the auditor's assessment of risk is judgmental and may not identify all risks of material misstatement and (ii) inherent limitations to internal control exist, including management override.

Depending on the circumstances, the auditor may determine the following:

- Performing only substantive analytical procedures will be sufficient to reduce audit risk to an acceptably low level, such as, for example, when the auditor's assessment of risk is supported by audit evidence from tests of controls.
- Only tests of details are appropriate.
- A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.

Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time.

The nature of the risk and assertion is relevant to the design of tests of details. For example, tests of details related to the existence or occurrence assertion may involve selecting from items contained in a financial statement amount and obtaining the relevant audit evidence. On the other hand, tests of details related to the completeness assertion may involve selecting from items that are expected to be included in the relevant financial statement amount and investigating whether they are included. For example, the auditor might inspect subsequent cash disbursements and compare them with the recorded accounts payable to determine whether any purchases had been omitted from accounts payable.

Because the assessment of the risks of material misstatement takes account of internal control, the extent of substantive procedures may need to be increased when the results from tests of controls are unsatisfactory. However, increasing the extent of an audit procedure is appropriate only if the audit procedure itself is relevant to the specific risk.

In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size. However, other matters also are relevant, including whether it is more effective to use other selective means of testing.

**The auditor should consider whether external confirmation procedures are to be performed as substantive audit procedures.**

External confirmation procedures frequently may be relevant when addressing assertions associated with account balances and their elements but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements, contracts, or transactions between an entity and other parties. External confirmation procedures also may be performed to obtain audit evidence about the absence of certain conditions. For example, a request may specifically seek confirmation that no side agreement exists that may be relevant to an entity's revenue cut-off assertion. Other situations in which external confirmation procedures may provide relevant audit evidence in responding to assessed risks of material misstatement include the following:

- Bank balances and other information relevant to banking relationships
- Inventories held by third parties at bonded warehouses for processing or on consignment
- Property title deeds held by lawyers or financiers for safe custody or as security
- Investments held for safekeeping by third parties or purchased from stockbrokers but not delivered at the balance sheet date
- Amounts due to lenders, including relevant terms of repayment and restrictive covenants
- Accounts payable balances and terms

Although external confirmations may provide relevant audit evidence relating to certain assertions, some assertions exist for which external confirmations provide less relevant audit evidence. For example, external confirmations provide less relevant audit evidence relating to the recoverability of accounts receivable balances than they do of their existence.

The auditor may determine that external confirmation procedures performed for one purpose provide an opportunity to obtain audit evidence about other matters. For example, confirmation requests for bank balances often include requests for information relevant to other financial statement assertions. Such considerations may influence the auditor's decision about whether to perform external confirmation procedures.

Factors that may assist the auditor in determining whether external confirmation procedures are to be performed as substantive audit procedures include the following:

- The confirming party's knowledge of the subject matter. Responses may be more reliable if provided by a person at the confirming party who has the requisite knowledge about the information being confirmed.
- The ability or willingness of the intended confirming party to respond. For example, the confirming party:
  - may not accept responsibility for responding to a confirmation request,
  - may consider responding too costly or time consuming,
  - may have concerns about the potential legal liability resulting from responding,
  - may account for transactions in different currencies, or
  - may operate in an environment in which responding to confirmation requests is not a significant aspect of day-to-day operations.

In such situations, confirming parties may not respond, may respond in a casual manner, or may attempt to restrict the reliance placed on the response. If the confirming party is a related party of the entity, responses to confirmation requests may be less reliable.

For purposes of this section, *accounts receivable* means the entity's claims against customers that have arisen from the sale of goods or services in the normal course of business; and a financial institution's loans.

External confirmation procedures may be ineffective when, based on prior years' audit experience or experience with similar entities response rates to properly designed confirmation requests will be inadequate; or responses are known or expected to be unreliable.

If the auditor has experienced poor response rates to properly designed confirmation requests in prior audits, the auditor may instead consider changing the manner in which the confirmation process is performed, with the objective of increasing the response rates, or may consider obtaining audit evidence from other sources.

**The auditor should use external confirmation procedures for accounts receivable, except when one or more of the following is applicable:**

- **The overall account balance is immaterial.**
- **External confirmation procedures for accounts receivable would be ineffective.**
- **The auditor's assessed level of risk of material misstatement at the relevant assertion level is low, and the other planned substantive procedures address the assessed risk. In many situations, the use of external confirmation procedures for accounts receivable and the performance of other substantive procedures are necessary to reduce the assessed risk of material misstatement to an acceptably low level.**

**The auditor's substantive procedures should include audit procedures related to the financial statement closing process, such as**

- **Agreeing or reconciling the financial statements with the underlying accounting records and**
- **Examining material journal entries and other adjustments made during the course of preparing the financial statements.**

The nature and also the extent of the auditor's examination of journal entries and other adjustments depends on the nature and complexity of the entity's financial reporting process and the related risks of material misstatement.

**If the auditor has determined that an assessed risk of material misstatement at the relevant assertion level is a significant risk, the auditor should perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures should include tests of details.**

The auditor is required to perform substantive procedures that are specifically responsive to risks the auditor has determined to be significant risks. Audit evidence in the form of external confirmations received directly by the auditor from appropriate confirming parties may assist the auditor in obtaining audit evidence with the high level of reliability that the auditor requires to respond to significant risks of material misstatement, whether due to fraud or error. For example, if the auditor identifies that management is under pressure to meet earnings expectations, a risk may exist that management is inflating sales by improperly recognizing revenue related to sales agreements with terms that preclude revenue recognition or by invoicing sales before shipment. In these circumstances, the auditor may, for example, design external confirmation procedures not only to confirm outstanding amounts but also to confirm the details of the sales agreements, including date, any rights of return, and delivery terms. In addition, the auditor may find it effective to supplement such external confirmation procedures with inquiries of nonfinancial personnel in the entity regarding any changes in sales agreements and delivery terms.

**If substantive procedures are performed at an interim date, the auditor should cover the remaining period by performing**

- **Substantive procedures, combined with tests of controls for the intervening period, or**
- **If the auditor determines that it is sufficient, further substantive procedures only,**

**that provide a reasonable basis for extending the audit conclusions from the interim date to the period-end.**

In most cases, audit evidence from a previous audit's substantive procedures provides little or no audit evidence for the current period. However, exceptions exist (for example, a legal opinion obtained in a previous audit related to the structure of a securitization to which no changes have occurred may be relevant in the current period). In such cases, it may be appropriate to use audit evidence from a previous audit's substantive procedures if that evidence and the related subject matter have not fundamentally changed and audit procedures have been performed during the current period to establish its continuing relevance.

In some circumstances, the auditor may determine that it is effective to perform substantive procedures at an interim date and compare and reconcile information concerning the balance at the period-end with the comparable information at the interim date to:

- Identify amounts that appear unusual,
- Investigate any such amounts, and
- Perform substantive analytical procedures or tests of details to test the intervening period.

Performing substantive procedures at an interim date without undertaking additional procedures at a later date increases the risk that the auditor will not detect misstatements that may exist at the period-end. This risk increases as the remaining period is lengthened. Factors such as the following may influence whether to perform substantive procedures at an interim date:

- The effectiveness of the control environment and other relevant controls
- The availability at a later date of information necessary for the auditor's procedures
- The purpose of the substantive procedure
- The assessed risk of material misstatement
- The nature of the class of transactions or account balance and relevant assertions
- The ability of the auditor to perform appropriate substantive procedures or substantive procedures combined with tests of controls to cover the remaining period in order to reduce the risk that misstatements that may exist at the period-end will not be detected

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



Factors such as the following may influence whether to perform substantive analytical procedures with respect to the period between the interim date and the period-end:

- Whether the period-end balances of the particular classes of transactions or account balances are reasonably predictable with respect to amount, relative significance, and composition
- Whether the entity's procedures for analyzing and adjusting such classes of transactions or account balances at interim dates and establishing proper accounting cutoffs are appropriate
- Whether the information system relevant to financial reporting will provide information concerning the balances at the period-end and the transactions in the remaining period that is sufficient to permit investigation of the following:
  - Significant unusual transactions or entries (including those at or near the period-end)
  - Other causes of significant fluctuations or expected fluctuations that did not occur
  - Changes in the composition of the classes of transactions or account balances

**If misstatements that the auditor did not expect when assessing the risks of material misstatement are detected at an interim date, the auditor should evaluate whether the related assessment of risk and the planned nature, timing, or extent of substantive procedures covering the remaining period need to be modified.**

**When designing tests of controls and tests of details, the auditor should determine the means of selecting items for testing that are effective in meeting the purpose of the audit procedure.**

An effective test provides appropriate audit evidence to the extent that it will be sufficient for the auditor's purpose when taken with other audit evidence obtained or to be obtained. In selecting items for testing, the auditor is required by section 500 to determine the relevance and reliability of information to be used as audit evidence; the other aspect of effectiveness (sufficiency) is an important consideration in selecting items to test. The means available to the auditor for selecting items for testing are

- Selecting all items (100 percent examination),
- Selecting specific items, and
- Audit sampling.

The application of any one or combination of these means may be appropriate depending on the particular circumstances (for example, the risks of material misstatement related to the assertion being tested and the practicality and efficiency of the different means).

**Selecting All Items** The auditor may decide that it will be most appropriate to examine the entire population of items that make up a class of transactions or account balance (or a stratum within that population). A 100 percent examination is unlikely in the case of tests of controls; however, it may be more common for tests of details. A 100 percent examination may be appropriate when, for example:

- The population constitutes a small number of large value items,
- A significant risk exists and other means do not provide sufficient appropriate audit evidence, or
- The repetitive nature of a calculation or other process performed automatically by an information system makes a 100 percent examination cost effective.

**Selecting Specific Items** The auditor may decide to select specific items from a population. In making this decision, factors that may be relevant include the auditor's understanding of the entity, the assessed risks of material misstatement, and the characteristics of the population being tested. The judgmental selection of specific items is subject to nonsampling risk. Specific items selected may include:

- High value or key items. The auditor may decide to select specific items within a population because they are of high value or exhibit some other characteristic (for example, items that are suspicious, unusual, particularly risk prone, or have a history of error).
- All items over a certain amount. The auditor may decide to examine items whose recorded values exceed a certain amount in order to verify a large proportion of the total amount of a class of transactions or account balance.
- Items to obtain information. The auditor may examine items to obtain information about matters such as the nature of the entity or the nature of transactions.

Although selective examination of specific items from a class of transactions or account balance often will be an efficient means of obtaining audit evidence, it does not constitute audit sampling. Consequently, the results of audit procedures applied to items selected in this way cannot be projected to the entire population; furthermore, selective examination of specific items does not, by itself, provide sufficient appropriate audit evidence concerning the remainder of the population.

**Audit Sampling** Audit sampling is designed to enable conclusions to be drawn about an entire population on the basis of testing a sample drawn from the population. Valid conclusions ordinarily may be drawn using sampling approaches. However, if the sample size is too small, the sampling approach or the method of selection is not appropriate to achieve the specific audit objective or exceptions are not appropriately followed up, an unacceptable risk will exist that the auditor's conclusion based on a sample may be different from the conclusion reached if the entire population was subjected to the same audit procedure.

**The auditor should perform audit procedures to evaluate whether the overall presentation of the financial statements, including the related disclosures, is in accordance with the applicable financial reporting framework.**

Evaluating the overall presentation of the financial statements, including the related disclosures, relates to whether the individual financial statements are presented in a manner that reflects the appropriate classification and description of financial information and the form, arrangement, and content of the financial statements, including the related notes. This includes, for example, the terminology used, the amount of detail given, the classification of items in the financial statements, and the basis of amounts set forth.

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

An audit of financial statements is a cumulative and iterative process. As the auditor performs planned audit procedures, the audit evidence obtained may cause the auditor to modify the nature, timing, or extent of other planned audit procedures. Information may come to the auditor's attention that differs significantly from the information on which the risk assessments were based. For example:

- The extent of misstatements that the auditor detects by performing substantive procedures may alter the auditor's professional judgment about the risk assessments and indicate a significant deficiency or material weakness in internal control.
- The auditor may become aware of discrepancies in accounting records or conflicting or missing evidence.
- Analytical procedures performed at the overall review stage of the audit may indicate a previously unrecognized risk of material misstatement.

In such circumstances, the auditor may need to reevaluate the planned audit procedures, based on the revised consideration of assessed risks for all or some of the classes of transactions, account balances, or disclosures and related assertions.

The auditor cannot assume that an instance of fraud or error is an isolated occurrence. Therefore, the consideration of how the detection of a misstatement affects the assessed risks of material misstatement is important in determining whether the assessment remains appropriate.

**The auditor should conclude whether sufficient appropriate audit evidence has been obtained. In forming a conclusion, the auditor should consider all relevant audit evidence, regardless of whether it appears to corroborate or contradict the assertions in the financial statements.**

The auditor's professional judgment about what constitutes sufficient appropriate audit evidence is influenced by such factors as the:

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

**If the auditor has not obtained sufficient appropriate audit evidence about a relevant assertion, the auditor should attempt to obtain further audit evidence. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor should express a qualified opinion or disclaim an opinion on the financial statements.**

## **Documentation**

**The auditor should include in the audit documentation:**

- **The overall responses to address the assessed risks of material misstatement at the financial statement level and the nature, timing, and extent of the further audit procedures performed;**
- **The linkage of those procedures with the assessed risks at the relevant assertion level; and**
- **The results of the audit procedures, including the conclusions when such conclusions are not otherwise clear.**

The form and extent of audit documentation is a matter of professional judgment and is influenced by the nature, size, and complexity of the entity; internal control of the entity; availability of information from the entity; and the audit methodology and technology used in the audit.

**If the auditor plans to use audit evidence about the operating effectiveness of controls obtained in previous audits, the auditor should include in the audit documentation the conclusions reached about relying on such controls that were tested in a previous audit.**

**The auditor should include in the audit documentation the basis for any determination not to use external confirmation procedures for accounts receivable when the account balance is material.**

**The auditor's documentation should demonstrate that the financial statements agree or reconcile with the underlying accounting records.**

## Chapter 2

### Obtaining an Understanding of Internal Controls

When the auditor obtains and documents the understanding of internal control, he or she should do so with an eye toward identifying deficiencies as the understanding is obtained. AU-C 265.07 provides:

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A deficiency in *design* exists when (a) a control necessary to meet the control objective is missing, or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met. A deficiency in *operation* exists when a properly designed control does not operate as designed or when the person performing the control does not possess the necessary authority or competence to perform the control effectively.

As the information is being gathered, the auditor should be alert to the first type of deficiency, that being a *design deficiency*. As noted above this type of deficiency exist when there either is no control in place, or where the control that management has established is not adequate to either prevent or detect and correct a misstatement that may occur. The second type of deficiency, an *operating deficiency* is normally identified when substantive procedures are applied and misstatements are discovered.

#### **The control environment**

Since the control environment is the foundation for all other components of internal control, the auditor focuses on it first. In smaller entities in particular, the activities and oversight of those charged with governance will frequently determine the overall quality of internal control. And all too often, governing boards (at least in governmental and nonprofit organizations, although it does occur in small business as well) allow themselves to be preoccupied with service delivery, taking a hands-off approach to all matters financial.

AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*, is very clear about the fact that ineffective oversight of the entity's financial reporting and internal control by those charged with governance is an indicator of a material weakness in internal control.

The standard simply states that the governing board's failure to oversee financial reporting and internal control is a material weakness, period. It cannot be considered any less than a material weakness, because in the small entity, the activities of the governing board are key to the control environment, and that environment is the foundation for internal controls.

Unfortunately, in many smaller entities, governing board members may not have backgrounds in financial matters, and therefore may not comprehend their roles as overseers of financial reporting and internal control. It is expected that the auditor and those charged should establish a close working relationship, in order to provide two-way communication between the auditor and those charged (one of the audit objectives of AU-C 260). The auditor is required to assess the adequacy of the two-way communications for audit purposes. If the communication process is deemed inadequate, the auditor is directed to consider the effect on the assessment of risk, as well as the ability to obtain sufficient appropriate evidence, and take appropriate action. It is usually incumbent upon the auditor to bring to the attention of the governing board the requirement for oversight of financial reporting and internal control. Developing a good relationship with the members of the governing board is the first step in opening the door for the required two-way communication.

Segregation of duties is a difficult thing to accomplish in smaller entity. Budget and space constraints may limit the entity's ability to hire highly trained persons or enough of them to adequately separate incompatible activities.

As such, the role of management and those charged in closely monitoring activities is paramount to accomplishing internal controls, and that is accomplished through *compensating controls*. Compensating controls don't *eliminate* deficiencies (such as segregation of duties) but *reduce the severity* of the deficiency, often to a point that conditions that would otherwise be reported as material weaknesses in internal control, may simply be reported as significant deficiencies, or in the best of cases, need not be reported at all.

The auditor must consider the extent to which those charged with governance are overseeing financial reporting and internal control. The following matters should be addressed:

- How often those charged with governance meet
- Whether an agenda is followed
- Whether minutes are recorded
- Whether the regular agenda includes a review of the entity's financial statements, and if so, what financial statements are provided to them and the extent of that review
- Whether the review of the financial statements provides for inquiries about unusual items
- The extent, if any, of the governing board's review and approval of expenditures

Beyond their regular oversight, those charged should provide (preferably written) guidance to employees (including management) regarding ethical behavior and conduct policies including conflicts of interest, and provide employees with some means to resolve any questions about ethical matters.

Management, of course, has the responsibility for carrying out internal controls. As such, management should provide a regular orientation process for new employees in order to communicate the policies established by the governing board. In addition, management is

responsible for selecting an appropriate financial reporting framework and accounting policies, and generally is responsible for hiring employees. In those respects, the auditor's concern should be whether the framework is appropriate, accounting policies are conservative, and that management attempts to hire the most competent persons available (given the limitations of the salary) and provide employees with adequate training necessary to perform their duties competently.

### **The entity's risk assessment process**

The entity's risk assessment process is about *business risk*, defined as follows:

A risk resulting from significant conditions, events, circumstances, actions, or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies or from the setting of inappropriate objectives and strategies. (AU-C 315.04)

Business risks may arise from:

- Changes in operating environment
- New personnel
- New or revamped information systems
- Rapid growth
- New technology
- New business models, products, or activities
- Corporate restructurings
- Expanded foreign operations
- New accounting pronouncements
- Changes in economic conditions
- Changes in laws or regulations

The entity's risk assessment process consists of:

- Identifying business risks relevant to the entity's financial reporting objectives
- Estimating the significance of the risks
- Assessing the likelihood of their occurrence, and
- Deciding on actions to assess those risks

If the entity has not established a process to identify business risk, or if the entity has an ad hoc process, the auditor should discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed. The auditor should evaluate whether the absence of a risk assessment process is appropriate in the circumstances or determine whether it represents a significant deficiency or material weakness in the entity's internal control.



In smaller entities, an auditor can expect little in the way of formal documentation of this process. In such cases, it is likely that management will identify risks through direct personal involvement in the operations. Irrespective of the circumstances, however, inquiry about identified risks and how they are addressed by management is still necessary. Generally, in obtaining the understanding of the entity and its environment (the objectives, strategies and the related risks), the auditor will become aware of the ways in which management and those charged with governance keep themselves aware of issues that could threaten the accomplishment of the organization's goals and objectives. This may occur through memberships in industry or trade associations and attendance at meetings of those organizations, subscriptions to industry publications, consultations with outside advisors (including legal counsel) about changes in the legal, regulatory or economic environment. As long as there are mechanisms in place to enable management and those charged to keep abreast of possible impediments to their goals, and those mechanisms have been reliable, the process may be considered adequate.

Where the auditor, however, has identified risks that management and those charged have not identified, there are obvious deficiencies in the process that will need to be reported.

**The information system, including the related business processes relevant to financial reporting and communication (Information and communication)**

Since most entities use off-the-shelf software and have no access to source code, the only issues related to information systems should be whether there is an appropriate backup of data files and the software is producing reports that are suitable to enable reasonable financial reporting and adequate oversight by those charged with governance. In general, monthly operating statements and budget-actual comparisons are essential to provide those charged with enough information to raise questions about unusual events or nonrecurring transactions.

Should the system be something other than PC-based or use specialized software, software maintenance and backup facilities (in the event of disaster) become important. In the event the entity does have access to source code, controls over program changes should be considered as well.

As a final matter on the information systems, the standard requires that auditors consider controls surrounding journal entries, including nonstandard journal entries used to record nonrecurring, unusual transactions, or adjustments. This may be addressed as part of the understanding of control activities, discussed below.

Communication involves not only the distribution of financial information generated by the accounting system, but other information as well, including how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting, including:

- Communications between management and those charged with governance and
- External communications, such as those with regulatory authorities.

Communications may be expected to occur in meetings of the governing board, or by mail (conventional or electronic), memorandum, staff meetings, bulletin boards, and through regular daily interaction between management, those charged with government and employees.

If adequate, reliable information is being provided to those who need it in a time frame that is conducive to decision making, the information and communication component can be considered to be adequate for the entity.

### **Control activities**

As a starting point in identifying the control activities the entity has in place, it may be helpful to begin with identifying the major accounting functions of the entity and how they relate to the classes of transactions that are significant to the financial statements. Many smaller entities maintain their records day to day on a cash basis, and the accounts are adjusted for accruals only at the end of the period (often with the assistance of the auditor). In that case, cash receipts and disbursements may be the only major functions (with payroll considered a subclass of cash disbursements that may require additional attention). In larger or more complex entities, additional accounting functions may include revenue/receivable recognition, purchasing/accounts payable, payroll and more.

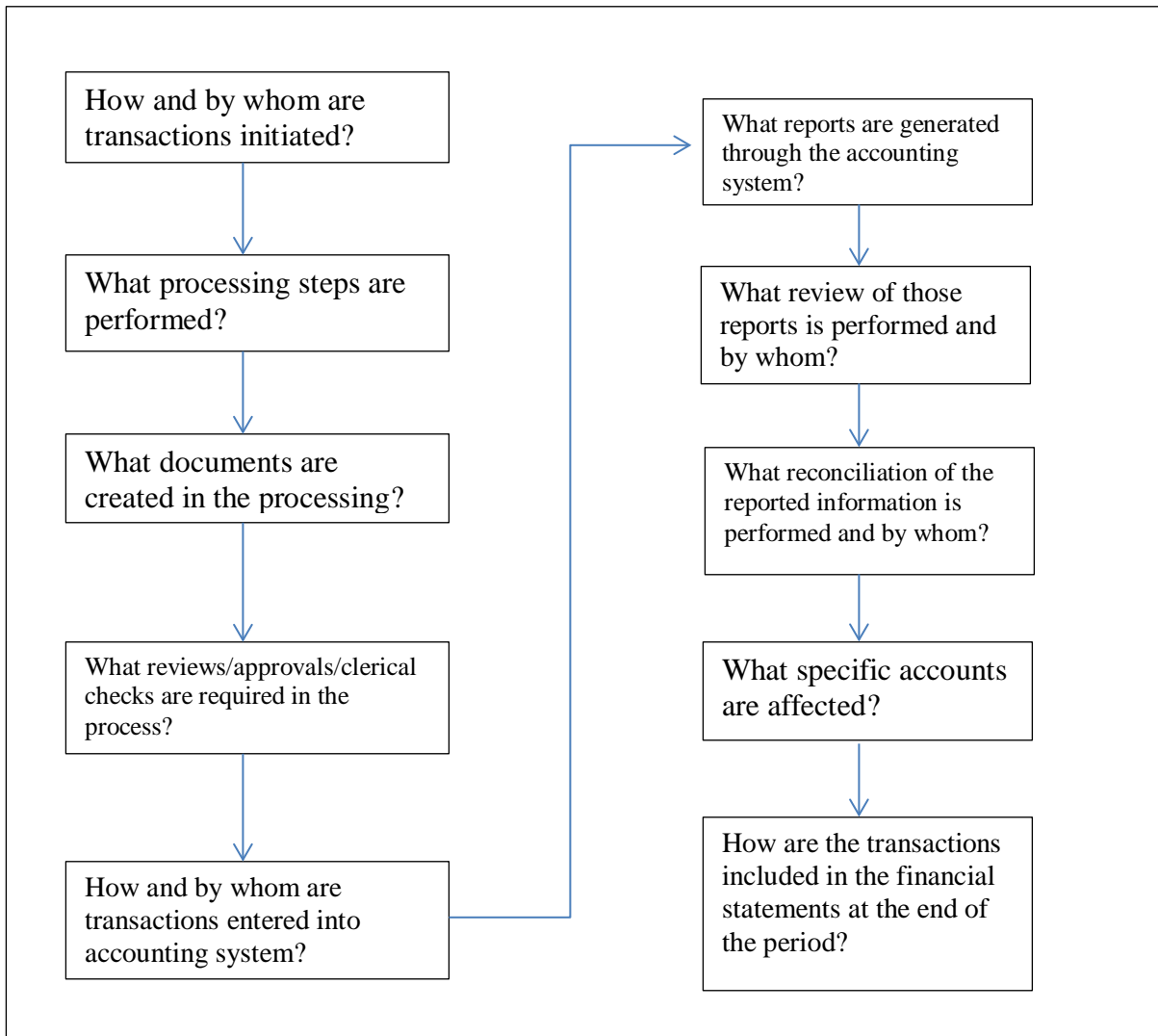
Subclasses of transactions may need to be considered as well. For example, when most transactions are recorded based on cash receipts or disbursements, payroll, fixed asset and long-term debt transactions (which ultimately affect either receipts or disbursements) may be subject to control activities beyond those that apply to routine cash receipts or disbursements.

Whatever the entity's structure, the auditor must first identify the areas that are significant to the entity's financial statements. An area may be significant because of:

- The volume of transactions processed (such as cash transactions)
- The dollar amounts of the transactions or balances (relative to other items in the financial statements, e.g. payroll, fixed assets, inventories, long-term debt)
- An identified fraud risk
- An identified other (error) misstatement risk.

Once the significant areas have been identified, the auditor focuses on the process that applies to that area. In developing the required understanding of control activities in the significant audit areas, the following diagram may be helpful:

**Exhibit 2**  
**Understanding an Accounting Control Process**



This general diagram illustrates what issues the auditor needs to address, regardless of the process being considered. It allows the auditor to follow any transaction, from its initiation to its ultimate inclusion in the financial statements. Since each step is essential to adequate control activities, as each step in the process is documented, the auditor should focus on design deficiencies in the step and how it could be improved, including the use of compensating controls.

For example, when considering the purchasing process, the auditor may determine that there is little or no process in place to authenticate an invoice before it is processed for payment. There may be no purchase orders in use (a problem with the initiation of a disbursement transaction), or any review and approval of the invoice by management to determine that the goods or services were actually received (a problem with review/approval/clerical checks).

## **Monitoring**

AU-C 315.23 - .25 require that the auditor obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting, including those related to those control activities relevant to the audit, and how the entity initiates remedial actions to deficiencies in its controls.

The auditor should also obtain an understanding of the sources of the information used in the entity's monitoring activities and the basis upon which management considers the information to be sufficiently reliable for the purpose. Much of the information used in monitoring may be produced by the entity's information system. If management assumes that data used for monitoring are accurate without having a basis for that assumption, errors that may exist in the information could potentially lead management to incorrect conclusions from its monitoring activities.

In smaller entities, management's monitoring of controls often is accomplished by management's or the owner-manager's close involvement in operations. This involvement often will identify significant variances from expectations and inaccuracies in financial data leading to remedial action to the control.

### **What is the point of all this?**

Having obtained and documented the understanding of internal controls and having applied the risk assessment procedures, the principal questions on the auditor's mind at this point should be:

- What *design deficiencies* in internal control am I aware of as a result of the understanding I have gained and how do those design deficiencies contribute to the risk of material misstatement in the financial statements?
- What other risks do I see from the results of the risk assessment procedures (inquiry, analytical procedures, inspection and observation)?
- What will I need to do to respond, in terms of extending audit procedures, to address those risks?

How the auditor responds will be based on the information obtained from:

- The required understanding of the entity and its environment
- The information about internal controls over key areas
- The appropriate risk assessment procedures

Of course, it is impossible to address all circumstances that an auditor might encounter. But continuing the above example, assume that the auditor has determined that there are no purchase orders in use, no authentication of invoices prior to payment, and no determination by management that goods or services were received. The auditor may judge it appropriate to perform an extensive detail test of cash disbursements, reviewing supporting documents for authenticity, assessing the need for the goods or services, the reasonableness of the quantities and amounts, determining that there is evidence they were received, etc.

Or assume that in the preliminary analytical procedures, trend analysis performed indicates that accounts payable is unexpectedly low, compared to prior periods, with no discernable explanation. The auditor may conclude that the search for unrecorded liabilities should be extended by lowering the dollar threshold of subsequent disbursement items to be tested, or extending the review of unprocessed invoices.

Whatever the issue, the auditor will have to exercise judgment in determining the appropriate response to any identified risks. Responding to risk is a matter of professional judgment, that takes into account all information available to the auditor at any point in the engagement (since it is an ongoing process). Responding to the auditor's risk assessment is the process of designing an audit plan (the sum total of the audit programs) that will provide the auditor with sufficient appropriate evidence that the financial statements are not materially misstated.

It is important to recall that risk assessments occur at two levels:

- The financial statement level, and
- The assertion level

Assessing risk at the financial statement level is simply a matter of identifying (in the financial statements and notes) where the issues reside. Unfortunately, risk at that level cannot be effectively dealt with, and thus the risk assessment is transferred to the assertion level by considering what types of misstatements are most likely to occur, and then considering to which of the assertions that type of misstatement relates.

Most commercially available audit programs are going to have certain basic procedures that will address, at least minimally, all of the assertions. The questions an auditor must ask and more importantly *answer* is “What are the most likely misstatements that might occur in this account balance, class of transactions or disclosure?” and “What procedures should I add (to the basic procedures) that will provide the evidence about whether they have or have not occurred?”

### Chapter 3

## Cash and Cash Equivalents

It has been said many times that cash is the most over-audited account on any balance sheet. Especially for those of us who remember when bank statements, checks and deposits were pretty much manually processed, the old habits sometimes die hard.

So what are the significant risks of material misstatement related to cash and cash equivalents? Circumstances of course vary from entity to entity, but in general terms, we can consider possible misstatements in terms of the assertions, related specifically to cash and cash equivalents.

*Existence* misstatements would mean that recorded cash is nonexistent – that there are amounts presented in the financial statements that are not on hand, on deposit in the entity’s name, or in transit to the entity’s accounts, or conversely, there are cash expenditures that have not been recorded. A general understanding of the deposit accounts and other items that make up the line item for cash and cash equivalents should enable the auditor, applying the basic procedures, to be satisfied that cash and cash equivalents do in fact exist.

Conditions that may indicate higher risk for existence:

- The reconciliation process is nonexistent or irregular
- There is no supervisory review of bank statements and contents prior to reconciliation
- There is no supervisory review of the completed reconciliations
- Controls over bank debit cards, EFT (electronic funds transfers) or other ACH (automated clearing house) transactions are weak or nonexistent

*Completeness* misstatements would mean that there are cash, deposit accounts or other cash items owned by the entity that are not presented in the financial statements. Someone has established cash accounts (or stashes of cash) that are “off the books” by diverting the entity’s receipts from being deposited as intended. This possibility is best dealt with from the revenue/receivables standpoint, and will be addressed later in the material.

Conditions that may indicate a higher risk for completeness:

- There is no control over the entity’s incoming mail (assuming bank statements and other bank correspondence are received by mail)
- Depository institutions have not been instructed to hold all statements and other correspondence for pickup by authorized persons (if not received by mail)
- Cash is not deposited regularly
- Cash on hand appears excessive
- Cash deposits are not balanced with cash receipts
- There is no supervisory review of bank statements and contents prior to reconciliation

- There is no supervisory review of completed reconciliations

*Valuation* misstatements would mean that cash in the financial statements is presented at inappropriate amounts. Since cash and cash equivalents are normally not subject to valuation misstatements (assuming there are no foreign currency issues), this should generally be a low risk assertion.

*Rights and obligations* misstatements would mean that any restrictions are not identified and disclosed, that restricted cash and cash equivalents are not reported separately from unrestricted amounts, and that cash and cash equivalent balances are not appropriately insured or secured by adequate collateral pledges.

Conditions that may indicate a higher risk for rights and obligations:

- There are complex restrictions on cash (such as sinking funds, reserve and similar funds required to be established by debt covenants) or requirements that certain cash be segregated from other accounts
- Management's lack of awareness or intentional disregard of the restrictions that exist
- Management's lack of understanding of FDIC coverage
- Absent or insufficient monitoring of collateral pledges and the related bank balances

The auditor may specifically respond to increased risk by:

- Testing multiple reconciliations at interim dates (existence and completeness) by tracing reconciling items to subsequent bank statements and inspecting canceled checks, noting the dates on which the items cleared the bank
- Performing a proof of cash (existence and completeness)
- Detail testing of reconciling items included on the year-end reconciliation (existence and completeness) by tracing reconciling items to subsequent bank statements and inspecting canceled checks, noting the dates on which the items cleared the bank
- Examining supporting documents for significant reconciling items (existence and completeness)
- Examining supporting documents for bank debit card, EFT and ACH transactions (existence)
- Investigating any unusual or suspicious items noted (existence and completeness)
- Reviewing collateral pledges for adequacy at various points during the period (rights and obligations)
- Testing adequacy of restricted cash balances (rights and obligations)
- Reviewing confirmations or other documentation (such as minutes) for any restrictions on cash, guarantees, minimum balance requirements or designations of cash for specific purposes (rights and obligations)
- Reviewing bank transfers for several days prior to and after year-end to determine that transfers were recorded in the same period (existence, occurrence, cutoff)
- Counting cash on hand (existence)

- Examining original certificates of deposit on hand, noting whether any have been pledged to secure indebtedness (existence, rights and obligations)
- Selecting various dates and reviewing the cash receipts for those dates to determine that the total amount of the cash receipts and the daily deposit totals agree and that the names and deposit amounts on the cash receipts tickets match the deposit slips (existence, rights and obligations)



## Chapter 4

### Receivables and Revenues

Because of the connection between receivables and revenues, they are best evaluated and tested simultaneously. Again, the auditor considers the possible misstatements related to each in terms of the relevant assertions.

#### **For receivables:**

*Existence* misstatements for receivables would mean that the receivable is nonexistent – either because the revenue or other transaction that gave rise to the receivable did not occur (or meet appropriate revenue recognition criteria), or because the receivable has been collected, but the receipt was not recorded.

Conditions that would indicate higher risk for existence:

- The entity does not follow a practice of standard terms and conditions with respect to all customers (the existence of side agreements, rights of return or conditional transfers of goods or services)
- The entity does not have adequate controls over cash receipts transactions that assure that all customer receipts are posted to the accounts
- The entity does not balance accounts receivable detail to control accounts at regular intervals
- Analytical evidence, such as the number of days' revenue in receivables, indicates a substantial change in collection periods (generally *increases* in the number of days' revenue)
- There are significant disputes with debtors over receivable balances
- There are substantial accounts that are past-due or for which there has been little or no payment activity; general deterioration of the aging of accounts
- There are debit entries to accounts receivable control accounts from unusual sources (such as a general journal entry)
- The entity does not have adequate controls over sales returns or the issuance of credit memoranda
- There are large or unusual transactions affecting receivables at or near the end of the period, including after the end of the period
- There is no supervisory review of incoming mail (such as customer correspondence concerning receivables)
- Significant related-party receivables, particularly those arising from transactions outside the normal course of business

*Completeness* misstatements for receivables would mean that all receivables are not included in the financial statements, either because the related revenue transactions have not been recorded (such as unbilled receivable/revenues), because policies and procedures do not assure that information necessary to record receivables has been captured to permit recording, or because receivables may have been written off or adjusted inappropriately.

Conditions that would indicate a higher risk for completeness:

- The entity does not have adequate controls over revenue recognition, such as failure to account for the sequence of sales invoices or other revenue documentation
- The entity fails to account for and retain voided invoices or other revenue documentation
- The entity does not balance accounts receivable detail to control accounts at regular intervals
- Analytical evidence, such as the number of days' revenue in receivables, indicates a substantial change in collection periods (generally *decreases* in the number of days' revenue)
- There are credit entries to accounts receivable control accounts from unusual sources (such as a general journal entry)
- There are inadequate controls over shipping documents, such as accounting for sequences and integration with invoicing
- There are inadequate controls over charge-offs or other adjustments to receivables (such as limiting access to charge-off or adjustment transactions or lack of approval of charge-offs and adjustments)
- The entity uses a service organization in its revenue/receivable recording and collection process and service organization controls do not appear adequate related to completeness
- There are significant related-party transactions that may not be captured by the accounting system

*Valuation* misstatements would mean that receivables were recorded at the wrong amount, or that consideration has not been given to the collectability of the receivable.

Conditions that would indicate a higher risk for valuation:

- The entity personnel lack the necessary competence and skill to properly record transactions
- There are significant disputes with debtors over receivable balances
- There are substantial accounts that are past-due or for which there has been little or no payment activity; general deterioration of the aging of accounts
- There are inadequate controls over subsequent collections of accounts that have been charged off or have been delinquent for substantial periods
- There have been changes in the local economy or other general economic conditions that raise questions about the entity's ability to collect receivables

- Significant specific debtors that are in bankruptcy/reorganization or ceasing operations, such as a major customer or taxpayer
- There is insufficient credit history investigation and background checks of new customers

*Rights and obligations* misstatements would mean that there may be unidentified assignments or pledges of receivables, or that otherwise receivables are encumbered in some way.

Conditions that would indicate a higher risk for rights and obligations:

- There are no processes in place to identify pledges or assignments of receivables

**For revenues:**

*Occurrence* misstatements would mean that all revenue transactions did not occur.

Conditions that would indicate a higher risk for occurrence:

- The entity does not follow a practice of standard terms and conditions with respect to all customers (the existence of side agreements, rights of return or conditional transfers of goods or services)
- Analytical evidence, such as the number of days' revenue in receivables, indicates a substantial change in collection periods (generally *increases* in the number of days' revenue)
- There are substantial accounts that are past-due or for which there has been little or no payment activity; general deterioration of the aging of accounts
- There are credit entries to revenue accounts from unusual sources (such as a general journal entry)
- There are large or unusual transactions affecting revenues at or near the end of the period, including after the end of the period
- There are significant performance related bonuses or other incentive compensation arrangements
- The entity is having difficulty meeting debt covenants related to revenue or profitability, or the expectations of owners, investors or third parties (such as contributors, creditors or taxpayers)

*Completeness* misstatements would mean that all revenues that did occur have not been recorded in the financial statements.

Conditions that would indicate a higher risk for completeness:

- There is no control over the entity's incoming mail (assuming bank statements and other bank correspondence are received by mail)

- Depository institutions have not been instructed to hold all statements and other correspondence for pickup by authorized persons (if not received by mail)
- There is no supervisory review of bank statements and incoming mail prior to distribution
- Substantive analytical procedures (such as predictive tests of revenues) indicate that recorded revenue is substantially less than predictions
- The entity does not have adequate controls over revenue recognition, such as failure to account for the sequence of sales invoices or other revenue documentation
- The entity fails to account for and retain voided invoices or other revenue documentation
- The entity uses a service organization in its revenue recording and collection process and service organization controls do not appear adequate related to completeness

*Accuracy* misstatements would mean that revenues were recorded at inappropriate amounts.

Conditions that would indicate a higher risk for accuracy:

- The entity's personnel lack the competence and skills to properly record transactions
- Revenue transactions require complex calculations or extended processes in order to determine the amount of the transactions
- Revenue transactions are subject to retroactive review and adjustment by outside parties (for example, health care providers or government contractors)

*Cutoff* misstatements would mean that revenues were recorded in the wrong period.

Conditions that would indicate a higher risk for cutoff:

- There are inadequate controls over revenue recording related to the cutoff of revenue transactions, such as those related to sales of goods and services and shipments at or near the end of the period
- The entity is having difficulty meeting debt covenants related to revenue or profitability, or the expectations of owners, investors or third parties (such as contributors, creditors or taxpayers)

*Classification* misstatements would mean that revenue was recorded in an inappropriate category.

Conditions that would indicate a higher risk for classification:

- The entity's personnel lack the competence and skills to properly classify transactions
- Analytical procedures (such as trend analysis, budget-actual comparisons) indicate substantial fluctuation in revenue categories

The auditor may specifically respond to a higher risk by:

- Testing the aging of accounts receivable by reference to subsidiary ledgers and underlying sales invoices and collection documentation (existence, valuation, occurrence, accuracy)
- Extending the confirmation process by increasing the number of accounts confirmed or lowering the threshold for confirmation (existence, occurrence, rights and obligations, accuracy, classification)
- Confirming selected accounts that have been adjusted, have a history of slow payment, have unusual payment terms or are new customers (existence, occurrence, rights and obligations, accuracy, classification)
- Following up nonreplies with a telephone call (existence, occurrence, rights and obligations, accuracy, classification)
- Reviewing supporting documentation for receivables for which there are no subsequent payments (existence, occurrence, rights and obligations, accuracy, classification)
- Verifying confirmations received by fax or email by telephone (existence, occurrence, rights and obligations)
- Tracing individual account charge-offs to authorization by supervisory personnel (existence, occurrence, valuation)
- Discussing significant delinquent accounts with management, and review supporting documentation for client explanations (credit files, correspondence, etc.) (existence, occurrence, valuation)
- Examining documentation supporting charge-offs and adjustments and considering whether accounts charged off were included in bad debt allowances at year end (existence, occurrence, valuation)
- Reviewing subsequent collections on accounts by reference to deposit slips and remittance advices and matching cash receipts to specific invoices (existence, occurrence, valuation)
- Reviewing creditworthiness and collateral pledged on delinquent receivables (existence, occurrence, valuation)
- Comparing revenue by category to prior periods (existence, occurrence, classification)
- Inquiring about steps taken to ensure all transactions and balances have been included in the financial statements (existence, completeness, occurrence)
- Selecting a sample of original shipping documents and trace the information to the related sales invoices; recomputing the invoice amounts (completeness, accuracy, classification)
- Scanning sales or revenue journals for a period before and after year-end, investigating any unusual items (cutoff)
- Comparing revenue for the last month of the year to revenue for the rest of the year and the first month after year-end (cutoff)
- Comparing sales returns and credit memoranda after year-end to balances at year end (valuation, cutoff)

- Examining shipping documents for last few days of the year and first few days of subsequent period to determine they are recorded in the proper period (cutoff)
- Inquiring of sales or other personnel about transactions at or near year-end, and whether there were any unusual terms and conditions (cutoff)
- Examining supporting documentation for large or unusual revenue transactions at or near year-end (existence, occurrence, accuracy, classification)
- Considering moving interim confirmations to year-end (existence, completeness, accuracy, classification)
- Confirming with counterparty the existence (or nonexistence) of rights of return, side agreements, assignments, pledges or other unusual terms (existence, occurrence, rights and obligations)
- Accounting for the sequence of revenue/receivable documents (sales invoices or other) (existence, occurrence, completeness, accuracy)

## Chapter 5 Investments

Investments can represent a broad range of risk, depending on the amount and types of investments in which an entity may engage. If the entity's investments are certificates of deposit of more than 90 days, those may be audited with cash and cash equivalents, and generally are not indicative of high levels of risk. Other types of investments (derivatives, for example) represent substantial risks with respect to certain assertions.

If the entity has adopted an investment policy, or the types of investments are limited by law or regulation, the auditor should be familiar with the allowable types of investments and be alert to any investments outside the applicable guidelines.

### **For investments:**

*Existence* misstatements for investments would mean that recorded investments are not owned by the entity – that the investment transaction never occurred, or that investments have been liquidated without being recorded.

Conditions that would indicate higher risk for existence:

- The entity has invested in unregistered investments, or through broker-dealers whose credentials are dubious
- There is little or no recorded investment income
- Investments are not registered in the entity's name (such as when registered to the broker-dealer)
- The entity does not receive periodic statements relative to the investments

*Completeness* misstatements for investments would mean that the entity has investments that are not presented in the financial statements.

Conditions that would indicate a higher risk for completeness:

- Investment income appears unusually high for the amounts invested

*Valuation* misstatements for investments would mean that the investments are presented at inappropriate amounts (cost rather than fair value, for example) or that fair value amounts are not based on trades of the identical investments in active markets (level 1), similar investments or investments traded in markets that are inactive (level 2), or reasonable estimates based on the entity's own assumptions (level 3). In general terms, the further down the valuation hierarchy the fair value determination, the higher the risk.

Conditions that would indicate higher risk for valuation:

- Fair value is difficult to determine, such as when the investments are closely held and little information is available on which to assess fair value (there is no market established, few, if any, trades and no readily available financial statements for the investee)
- The entity uses an outside party (such as a pricing service or the broker-dealer) to establish fair value
- Fair values are based on the entity's own assumptions, particularly where those assumptions are difficult to support
- The entity's personnel may lack the competence and skill to estimate fair value or record changes in fair value
- The entity invests in complex investment instruments (derivatives or convertible securities)
- The entity's equity method investee (or joint venture) cannot produce audited financial statements
- The investment counterparty's creditworthiness is in question or it is in bankruptcy or reorganization (bonds or notes)
- Management seems prone to taking unreasonable investing risks in unproven or unconventional investments (such as real estate)
- Management has a history of violating investment laws, regulations or policies
- The entity has no investment policy

*Rights and obligations* misstatements would mean that investments are somehow encumbered, such as having been pledged as collateral, or that there may be restrictions on the entity's ability to liquidate the investment.

Conditions that indicate higher risks for rights and obligations:

- Investment agreements are complex, or may limit the entity's ability to withdraw amounts invested (such as hedge funds)
- The entity has loans or other debt at below-market rates

**For investment income:**

*Occurrence* misstatements for investment income would mean that investment income was not earned or was otherwise overstated.

Conditions indicating higher risks for occurrence:

- Investment income is accrued but there are no subsequent collections
- Investment gains are based on questionable fair value estimates
- Management may be motivated to overstate investment earnings



*Completeness* misstatements for investment income would mean that all investment income was not reported in the financial statements (note that this may include realized and unrealized gains and losses).

Conditions that would indicate higher risk for completeness:

- Investment income appears unusually low for the amounts invested

*Accuracy* misstatements for investment income would mean that investment income (and gains and losses) were recorded improperly.

Conditions that would indicate higher risk for accuracy:

- The entity's personnel responsible for investment transactions lack the competence and skill to accurately record investment revenue or gains and losses.
- There are extensive calculations required to accrue income or determine gains and losses

*Cutoff* misstatements would mean that investment revenue transactions and gains and losses were recorded in the wrong period.

Conditions that would indicate higher risk for cutoff:

- There are substantial investment income transactions at or near the end of the period

*Classification* misstatements would mean that investment earnings and gains and losses were recorded in the wrong categories.

Conditions that indicate higher risk for classification:

- Analytical procedures indicate potential misclassification of investment earnings, gains and losses

The auditor may specifically respond to increased risks by:

- For equity method investments or investments in hedge funds, obtaining and reading the relevant financial statements; requesting specific representations from other auditors who report on those financial statements (existence, occurrence, completeness, valuation)
- For derivative investments, reviewing board minutes or investment policies for authorization (existence, rights and obligations, occurrence)
- Identifying embedded derivatives by reviewing loan agreements, bond documents, and other relevant contracts (existence, completeness, rights and obligations)

- Confirming with counterparties or brokers the outstanding transactions at year-end (existence, completeness, rights and obligations)
- Tracing investment transactions to underlying trade slips (existence, rights and obligations)
- For derivatives designated as hedges, reviewing the entity's documentation of the hedging relationship for compliance with GAAP requirements (existence, rights and obligations)
- Tracing fair values to quoted market prices, if available (valuation)
- Testing the valuation methodology (testing the assumptions, model, underlying data) for investments for which fair value is estimated (valuation)
- For entities using pricing service, obtaining information about the service organization (valuation)
- Recalculating investment income, realized and unrealized gains and losses (occurrence, accuracy, classification)
- Engaging a valuation specialist to determine whether management's fair value estimates are fairly stated (valuation)

## Chapter 6 Property and Equipment

The risks of material misstatement related to fixed assets are normally not high. When fixed assets are purchased outright, the transactions are fairly simply to record and don't require fair value determination. However, there may be certain classes of transactions within the category that represent specific risks, such as constructed assets or leases.

### **For fixed assets:**

*Existence* misstatements for fixed assets would mean that recorded assets do not exist – they either never did exist, have been disposed of or destroyed without recognition of that fact, or have been removed from the entity's possession.

Conditions that would indicate higher risk for existence:

- Property or equipment is replaced, and there are no related dispositions of previously owned similar assets (such as office equipment)
- Equipment remains on depreciation schedules long after its expected useful life (such as computers or other electronic equipment)
- The entity has experienced some disaster (for example, fire, flood or other event) that may have destroyed or damaged property and equipment
- The entity has reported a robbery, break-in or similar event
- The entity inventories movable equipment and notes that items are unaccounted for
- The entity's personnel may lack the competence and skill to record disposition of property and equipment
- There may be complex legal requirements for disposition of property

*Completeness* misstatements for property and equipment would mean that there are fixed assets that are not presented in the financial statements. For purchased fixed assets, this should be a low-risk occurrence.

Conditions that would indicate higher risk for completeness:

- The entity is engaged in leasing property and equipment, and lease terms have not been reviewed to determine whether the lease should be capitalized.
- The entity is engaged in construction activity, and there has been no capitalization of interest
- The entity's personnel may lack the competence and skill to evaluate leases or determine the need to capitalize interest on construction
- Repairs and maintenance appears unusually high or excessive
- The entity's capitalization policy has an unusually high threshold

*Valuation* misstatements for fixed assets would mean that property and equipment are presented at inappropriate amounts in the financial statements. Again, for purchased fixed assets, this should be low-risk.

Conditions that would indicate higher risk for valuation:

- The entity's personnel lack the competence and skill to properly record fixed assets, in particular, leased or constructed assets, or to calculate and record depreciation or impairment losses
- The entity has experienced some disaster (fire, flood or other event) that may have damaged or impaired property and equipment
- Certain equipment may be subject to impairment due to obsolescence
- Certain assets may have been taken out of service or may be held for sale
- There are substantial donated assets (in governments and nonprofits)
- There are fixed assets contributed by an owner

*Rights and obligations* misstatements would mean that the entity may not have clear title to assets, or that there may be unrecognized claims or liens on property and equipment.

Conditions that would indicate higher risk for rights and obligations:

- The entity has entered a conditional sales contract (sometimes called a "bond-for-deed" contract)
- The entity has loan agreements that provide that the loans are secured by "all property"
- The entity is unable to obtain title insurance on real property acquired
- The entity may have disposed of property subject to a lien

**For depreciation expense and impairment losses:**

*Occurrence* misstatements would mean that depreciation expense or an impairment loss was inappropriately recorded.

Conditions that would indicate higher risk for occurrence:

- Depreciation may have been recorded on assets taken out of service or held for sale
- Useful lives may be excessively short
- The entity's personnel lack the competence and skill to calculate depreciation or determine an impairment loss

*Completeness* misstatements would mean that all depreciation expense or an impairment loss has not been recorded.

Conditions that would indicate higher risk for completeness:

- The entity's personnel lack the competence and skill to calculate depreciation or recognize that fixed assets are impaired
- Useful lives may be excessively long
- The methodology used to calculate an impairment loss may be inappropriate

*Accuracy* misstatements would mean that depreciation expense or an impairment loss was improperly calculated. *Cutoff* misstatements would mean that depreciation expense or an impairment loss was recorded in the wrong period. *Classification* misstatements would mean that depreciation expense or an impairment loss was recorded in the wrong accounts.

Conditions that would indicate higher risk for accuracy, cutoff and classification:

- The entity's personnel lack the competence and skill to correctly calculate and record depreciation expense or an impairment loss

The auditor may specifically respond to increased risks by:

- Reviewing lease agreement terms and conditions for capitalization criteria (existence, completeness, valuation)
- Recalculating lease assets and liabilities (existence, completeness, valuation)
- Reviewing construction invoices, and other costs, considering whether interest costs have been capitalized (existence, completeness, valuation)
- Recalculating capitalized interest (completeness, valuation)
- Reviewing fixed asset invoices for equipment that may have been traded (existence)
- Analyzing miscellaneous income or other income for possible proceeds from sales of property and equipment (existence, occurrence)
- Reviewing insurance claims filed as a result of disaster for property and equipment damage (existence)
- Requesting and reviewing police reports of thefts, break-ins or robberies (existence)
- Obtaining moveable equipment inventory and locating selected items (existence)
- Analyzing repairs and maintenance accounts for items that should be capitalized (completeness)
- Reviewing capitalization policy for reasonableness (completeness)
- Recalculating depreciation expense (occurrence, completeness, accuracy, cutoff classification)
- Recalculating impairment losses (occurrence, completeness, accuracy, cutoff, classification)
- Reviewing useful lives for reasonableness (occurrence, completeness)
- Inspecting property and equipment (existence)
- Reviewing sales contracts for conditional sale criteria (rights and obligations)
- Reviewing loan agreements for collateral (rights and obligations)

- Reviewing title insurance contracts (rights and obligations)
- Reviewing insurance policies for equipment descriptions, loss payees (existence, rights and obligations)
- Engaging a valuation specialist (e.g. an appraiser) for donated assets

## Chapter 7

### Current Liabilities and the Related Expenses

Current liabilities include accounts payable and accrued expenses, the current portion of long-term debt, and payroll and other withholdings. As we move to the other side of the balance sheet, completeness generally becomes more important.

#### **For current liabilities:**

*Existence* misstatements for current liabilities would mean that recorded liabilities do not exist at the balance sheet date or are overstated.

Conditions that would indicate higher risk for existence:

- The entity's personnel may lack the competence and skill to properly record current liabilities or calculate and accrue liabilities
- The detailed listing of current liabilities does not agree with the recorded amounts
- Vendor accounts are not regularly reconciled to statements
- Analytical procedures indicate an unexplained increase in current liabilities
- Management may be motivated to overstate liabilities (such as during a proposed partition or property settlement)
- There is inadequate control over credit cards issued in the entity's name
- Vendor lists are not regularly reviewed by supervisory personnel
- There are inadequate controls over the purchasing function
- There are inadequate controls over invoice approval and authorization

*Completeness* misstatements for current liabilities would mean that all current liabilities have not been presented in the financial statements or that current liabilities are understated.

Conditions that would indicate higher risk for completeness:

- The entity is having difficulty meeting debt covenants related to current ratio, debt/equity ratio, or the profitability expectations of owners, investors or third parties (such as lenders, contributors, creditors or taxpayers)
- Management may be otherwise motivated to understate liabilities (such as when there are significant performance-related bonuses, or a pending sale of the entity)
- Analytical procedures indicate an unexplained decrease in current liabilities
- The entity's personnel may lack the competence and skill to properly record current liabilities or calculate and accrue liabilities
- There are significant disputes over balances with vendors or creditors
- Vendor accounts are not regularly reconciled to statements
- There is no supervisory review of incoming mail
- There is inadequate control over credit cards issued in the entity's name

- There are debit entries to the liability accounts from unusual sources, such as general journal entries
- The detailed listing of current liabilities does not agree with the recorded amounts
- There are significant violations of long-term debt covenants and management has not obtained a written waiver of the provisions from the debt holder

*Valuation* misstatements would mean that current liabilities are not presented at the appropriate amounts in the financial statements. This should generally be a low-risk assertion, at least for accounts payable and withholdings. For accrued liabilities, risk may be higher.

Conditions that would indicate higher risk for valuation:

- There are numerous or complex calculations required to determine the amount to accrue
- There are amounts due in foreign currency that must be converted to U.S. dollars
- The entity's personnel may lack the competence and skill to accurately determine accruals
- There are inadequate controls over accumulated vacation, sick leave and other compensated absences
- There are significant estimated liabilities, such as warranties, self-insurance or similar items

*Rights and obligations* misstatements would mean that recorded current liabilities are not the obligations of the entity.

Conditions that would indicate higher risk for rights and obligations:

- There are inadequate controls over credit cards issued in the entity's name
- There are inadequate controls over the purchasing function
- There are inadequate controls over invoice approval and authorization
- Vendor lists are not regularly reviewed by supervisory personnel

**For the related expenses:**

*Occurrence* misstatements would mean that recorded expenses either did not occur or are overstated.

Conditions that would indicate higher risk for occurrence:

- The entity's personnel may lack the competence and skill to properly record or calculate and accrue expenses
- Management may be motivated to overstate expenses (such as during a proposed partition or property settlement)
- Vendor lists are not regularly reviewed by supervisory personnel



- There are inadequate controls over the purchasing function
- There are inadequate controls over invoice approval and authorization
- Analytical procedures indicate an unexplained increase in expenses

*Completeness* misstatements would mean that all expenses have not been recorded or that expenses are understated.

Conditions that would indicate higher risk for completeness:

- The entity is having difficulty meeting debt covenants related to profitability, or the expectations of owners, investors or third parties (such as lenders, contributors, creditors or taxpayers)
- Analytical procedures indicate an unexplained decrease in expenses
- The entity's personnel may lack the competence and skill to properly record expenses or calculate and accrue expenses
- Management may be otherwise motivated to understate expenses (such as when there are significant performance-related bonuses, or a pending sale of the entity)

*Accuracy* misstatements would mean that expenses have been recorded at the wrong amounts.

Conditions that would indicate higher risk for accuracy:

- There are significant expenses that must be estimated
- There are numerous or complex calculations required to determine the amount to record
- The entity's personnel may lack the competence and skill necessary to accurately record expenses

*Cutoff* misstatements would mean that expenses were recorded in the wrong period.

Conditions that would indicate higher risk for cutoff:

- The entity is having difficulty meeting debt covenants related to profitability, or the expectations of owners, investors or third parties (such as lenders, contributors, creditors or taxpayers)
- Analytical procedures indicate an unexplained decrease in expenses
- Management may be otherwise motivated to understate expenses (such as when there are significant performance-related bonuses, or a pending sale of the entity)

*Classification* misstatements would mean that the expenses were recorded in the wrong categories.

Conditions that would indicate higher risk for classification:

- Analytical procedures indicate significant fluctuations in expense line items
- The entity's employees may lack the competence and skill to properly classify expenses

The auditor may specifically respond to increased risks by:

- Obtaining schedules of accounts payable and other current liabilities and agree to supporting documents (existence, valuation, accuracy, classification, cutoff)
- Reviewing vendor lists, investigating any suspicious vendors or those with similar names such as by reference to telephone directories or the internet (existence, rights and obligations)
- Obtaining credit card statements and examining supporting documents for charges (existence, rights and obligations)
- Recalculating accrued or estimated liabilities (valuation, completeness, accuracy)
- Investigating unusual sources of postings to liability accounts (such as journal entries) (existence, completeness, rights and obligations)
- Increasing the scope of the search for unrecorded liabilities to include more items, such as in the review of subsequent transactions (completeness, cutoff)
- Confirming selected accounts payable, in particular those accounts in dispute (existence, completeness, rights and obligations)

## Chapter 8

# Long-Term Debt and Other Liabilities

Long-term liabilities vary significantly, and may include bonds, bank debt, other forms of borrowing, pensions and other post-retirement benefits, and asset retirement obligations.

*Existence* misstatements for long-term debt would mean that the obligations have been recorded when they should not have or that long-term obligations have been overstated.

Conditions that would indicate higher risk for existence:

- Management may be motivated to overstate liabilities (such as during a proposed partition or property settlement)
- The entity's personnel may lack the competence and skill to properly allocate debt service payments between principal and interest
- There are significant estimated long-term liabilities
- There are liabilities which may require discounting to present value (such as litigation and claims)

*Completeness* misstatements for long-term debt would mean that long-term obligations that should have been recorded have not been presented in the financial statements or are understated.

Conditions that would indicate higher risk for completeness:

- The entity is engaged in leasing property and equipment, and lease terms have not been reviewed to determine whether the lease liability should be recorded
- Interest expense appears excessive for the amount of debt recorded
- The entity has not assessed the need to retire certain assets (such as oil and gas facilities or removal of hazardous materials from its facilities)
- The entity has accounted for its pension and other post-retirement benefits on a pay-as-you-go basis or otherwise lacks the competence and skill to account for pensions and other post-employment benefits
- The entity has self-insured certain risks or is uninsured (or underinsured) with respect to property, liability, automobile, workers' compensation or other coverage
- The entity's personnel may lack the competence and skill to properly allocate debt service or other payments between principal and interest
- There are significant estimated long-term liabilities
- The entity is having difficulty meeting debt/equity or other debt-related ratios

*Valuation* misstatements would mean that long-term obligations were recorded at the wrong amounts.

Conditions that would indicate higher risk for valuation:

- Long-term obligations may have been discounted inappropriately
- There are amounts due in foreign currency that must be converted to U.S. dollars

*Rights and obligations* misstatements would mean that there are misstatements related to debt issuance or debt covenants.

Conditions that would indicate higher risk for rights and obligations:

- There are legal, regulatory or policy requirements that debt issuance be approved by voters, owners or the governing board
- There are restrictions on the types of debt the entity may issue
- There are complex debt covenants
- The entity is subject to legal debt limits
- The entity has issued debt with equity conversion features (such as preferred stock conversion rights)

The auditor may specifically respond to increased risks by:

- Obtaining and reviewing lease agreements for capitalization criteria (existence, completeness)
- Engaging a specialist to establish values for estimated long-term obligations, such as self-insurance, pensions and other post-employment benefits, or convertible debt (existence, completeness, valuation)
- Recalculating discounts applied to long-term obligations (completeness, valuation)
- Obtaining legal opinions regarding debt covenant compliance (rights and obligations)
- Requesting written waivers for debt covenant violations (completeness, rights and obligations)
- Confirming details of debt instruments with debt holders or lessors (existence, completeness, rights and obligations)
- Obtaining and reviewing amortization schedules (existence, completeness, valuation, rights and obligations)

## Chapter 9

### Equity

Depending on the type of entity under audit, the equity may be very simple (one account for residuals of each year's operations) or very complex (multiple classes of equity securities, accumulated other comprehensive income, restrictions on equity transactions, etc.).

*Existence* misstatements for equity would mean that the equity transaction did not occur or that equity accounts are otherwise overstated.

Conditions that would indicate higher risk for existence:

- There are multiple classes of stock, both common and preferred stock, or preferred stock with conversion features
- There are significant transactions in treasury stock
- The entity's personnel may lack the competence and skill necessary to properly record equity transactions
- There are recorded equity transactions for which the authorization or approval is not documented in the minutes, such as issuance of stock or payment of dividends
- There are entries to equity from unusual sources, such as the general journal
- There is no accounting for the sequence of stock certificates

*Completeness* misstatements would mean that all equity transactions have not been recorded or their effect on equity was understated.

Conditions that would indicate higher risk for completeness:

- There are declared but unpaid dividends
- There are significant transactions in treasury stock
- There are elements of comprehensive income present
- The entity's personnel may lack the competence and skill necessary to properly record equity transactions
- There are entries to equity from unusual sources, such as the general journal
- There is no accounting for the sequence of stock certificates

*Valuation* misstatements would mean that equity accounts are presented at the wrong amounts.

Conditions that would indicate higher risk for valuation:

- The entity's personnel may lack the competence and skill necessary to properly record equity transactions

*Rights and obligations* misstatements would mean that there are unidentified restrictions on equity.

Conditions that would indicate higher risk for rights and obligations:

- There are restrictions (such as on payment of dividends) on equity included in loan agreements or other documents
- There are complex buy-sell agreements that may limit transfers of ownership

The auditor may specifically respond to increased risk by:

- Obtaining information about equity transactions (such as stock sales) and comparing to the entity's stock certificate book or shareholders' ledger (existence)
- Accounting for sequences of stock certificates, including cancelations (existence, completeness, rights and obligations)
- Vouching equity transactions (such as dividend payments and treasury stock purchases) (existence, completeness, rights and obligations)
- Examining unissued stock certificates (completeness)
- Recalculating transaction amounts (existence, completeness, valuation)
- Confirming shares held with individual shareholders or other equity holders (existence, completeness)
- Confirming dividends paid, treasury stock acquired, and other transactions (completeness, valuation, rights and obligations)

## Chapter 10

# The Operating Statement

The major revenues and expenses have been addressed from the perspective of the related receivables and payables, and thus, the remaining items on the operating statement need to be considered. An analytical approach, including scanning of the accounting records, trend analysis, budget-actual comparisons is usually applied to identify areas of concern.

*Occurrence* misstatements would mean that recorded transactions either did not occur, or were overstated.

Conditions that would indicate higher risk for occurrence:

- Analytical procedures indicate balances that appear excessive, compared to historical amounts, budgeted amounts, or other expectations
- There are amounts identified that seem unusual, or raise questions about whether there was a purpose related to the entity's operations
- There are related party transactions not previously identified
- The reconciliation process is nonexistent or irregular
- There is no supervisory review of bank statements and contents prior to reconciliation
- There is no supervisory review of the completed reconciliations
- Large or unusual transactions are noted at or near the end of the period
- There are significant performance related bonuses or other incentive compensation arrangements
- The entity is having difficulty meeting debt covenants related to revenue or profitability, or the expectations of owners, investors or third parties (such as contributors, creditors or taxpayers)

*Completeness* misstatements would mean that all transactions have not been recorded in the accounting records or that amounts are understated.

Conditions that would indicate higher risk for completeness:

- Analytical procedures indicate balances that appear unusually low, compared to historical amounts, budgeted amounts, or other expectations
- Items that should be expected to appear in the accounting records do not appear at all
- There are inadequate controls over cash transactions
- The reconciliation process is nonexistent or irregular
- There is no supervisory review of bank statements and contents prior to reconciliation
- There is no supervisory review of the completed reconciliations
- Controls over bank debit cards, EFT (electronic funds transfers) or other ACH (automated clearing house) transactions are weak or nonexistent
- There are significant performance related bonuses or other incentive compensation arrangements

- The entity is having difficulty meeting debt covenants related to revenue or profitability, or the expectations of owners, investors or third parties (such as contributors, creditors or taxpayers)

*Accuracy* misstatements would mean that transactions are recorded at the wrong amounts.

Conditions that would indicate higher risk for accuracy:

- The reconciliation process is nonexistent or irregular
- There is no supervisory review of bank statements and contents prior to reconciliation
- There is no supervisory review of the completed reconciliations
- Controls over bank debit cards, EFT (electronic funds transfers) or other ACH (automated clearing house) transactions are weak or nonexistent
- The entity's personnel may lack the competence and skill necessary to accurately record transactions

*Cutoff* misstatements would mean that transactions were reported in the wrong period.

Conditions that would indicate higher risk for cutoff:

- The reconciliation process is nonexistent or irregular
- There is no supervisory review of bank statements and contents prior to reconciliation
- There is no supervisory review of the completed reconciliations
- The entity's personnel may lack the competence and skill necessary to record transactions in the appropriate period
- Large or unusual transactions are noted at or near the end of the period
- There are significant performance related bonuses or other incentive compensation arrangements
- The entity is having difficulty meeting debt covenants related to revenue or profitability, or the expectations of owners, investors or third parties (such as contributors, creditors or taxpayers)

*Classification* misstatements would mean that transactions are not coded to the correct accounts.

Conditions that would indicate higher risk for classification:

- The entity's personnel may lack the competence and skill necessary to record transactions properly
- Analytical procedures indicate lack of comparability in the accounts based on historical amounts, budget-actual comparison, or other expectations



The auditor may specifically respond to increased risks by:

- Selecting a sample of cash disbursements (non-payroll) for a vouching test and carefully reviewing supporting documents for all assertions (occurrence, completeness, accuracy, cutoff, classification)
- Performing a detailed payroll test, based on a sample of payroll transactions (occurrence, completeness, accuracy, cutoff, classification)
- Vouching other income accounts to supporting documents (occurrence, accuracy, cutoff, classification)
- Vouching specific transactions in accounts that appear unusually high or low or that may lack a purpose related to the entity's operations (occurrence, completeness, accuracy, cutoff, classification)
- Confirming specific transactions with counterparties (occurrence, completeness, accuracy, cutoff, classification)