

# Exhibit D

## AU-C Section 330

# ***Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained***

Source: SAS No. 122; SAS No. 134; SAS No. 135; SAS No. 136.

Effective for audits of financial statements for periods ending on or after December 15, 2012, unless otherwise indicated.

### NOTE

In July 2020, the Auditing Standards Board issued Statement on Auditing Standards (SAS) No. 142, *Audit Evidence*, which contains amendments to this section.

The amendments are effective for audits of financial statements for periods ending on or after December 15, 2022, and can be viewed in appendix B of section 500 until the effective date, when they will be applied to this section.

## Introduction

### Scope of This Section

.01 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. Section 700, *Forming an Opinion and Reporting on Financial Statements*, and section 703, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA*, address the auditor's responsibility to form an opinion on the financial statements based on the evaluation of the audit evidence obtained. [As amended, effective for audits of financial statements for periods ending on or after December 15, 2021, by SAS No. 136.]

### Effective Date

.02 This section is effective for audits of financial statements for periods ending on or after December 15, 2012.

### Objective

.03 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

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

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**Substantive procedure.** An audit procedure designed to detect material misstatements at the assertion level. Substantive procedures comprise

- a. tests of details (classes of transactions, account balances, and disclosures) and
- b. 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****Overall Responses**

**.05** The auditor should design and implement overall responses to address the assessed risks of material misstatement at the financial statement level. (Ref: par. .A1–.A3)

**Audit Procedures Responsive to the Assessed Risks of Material Misstatement at the Relevant Assertion Level**

**.06** 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. (Ref: par. .A4–.A9)

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

- a. 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
  - i. the likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (the inherent risk) and
  - ii. 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 (Ref: par. .A10–.A19)
- b. obtain more persuasive audit evidence the higher the auditor's assessment of risk. (Ref: par. .A20)

**Tests of Controls**

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

- a. 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

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the operating effectiveness of controls in determining the nature, timing, and extent of substantive procedures) or

- b. substantive procedures alone cannot provide sufficient appropriate audit evidence at the relevant assertion level. (Ref: par. .A21–.A26)

**.09** 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. (Ref: par. .A27)

### ***Nature and Extent of Tests of Controls***

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

- a. perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including
  - i. how the controls were applied at relevant times during the period under audit;
  - ii. the consistency with which they were applied; and
  - iii. 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 (Ref: par. .A28–.A32)
- b. 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. (Ref: par. .A33–.A34)

### ***Timing of Tests of Controls***

**.11** 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 paragraphs .12 and .15 that follow, in order to provide an appropriate basis for the auditor's intended reliance. (Ref: par. .A35)

#### ***Using Audit Evidence Obtained During an Interim Period***

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

- a. obtain audit evidence about significant changes to those controls subsequent to the interim period and
- b. determine the additional audit evidence to be obtained for the remaining period. (Ref: par. .A36–.A37)

#### ***Using Audit Evidence Obtained in Previous Audits***

**.13** 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

- a. 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;
- b. the risks arising from the characteristics of the control, including whether the control is manual or automated;
- c. the effectiveness of general IT controls;

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- d. 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;
- e. whether the lack of a change in a particular control poses a risk due to changing circumstances; and
- f. the risks of material misstatement and the extent of reliance on the control. (Ref: par. .A38)

**.14** 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

- a. 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. (Ref: par. .A39)
- b. 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. (Ref: par. .A40–.A42)

*Controls Over Significant Risks*

**.15** If the auditor plans to rely on controls over a risk the auditor has determined to be a significant risk,<sup>1</sup> the auditor should test the operating effectiveness of those controls in the current period.

*Evaluating the Operating Effectiveness of Controls*

**.16** 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. (Ref: par. .A43)

**.17** 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

- a. the tests of controls that have been performed provide an appropriate basis for reliance on the controls,
- b. additional tests of controls are necessary, or
- c. the potential risks of misstatement need to be addressed using substantive procedures. (Ref: par. .A44)

**Substantive Procedures**

**.18** Irrespective of the assessed risks of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions

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<sup>1</sup> Paragraphs .28–.30 of section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.

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related to each material class of transactions, account balance, and disclosure. (Ref: par. .A45–.A50)

**.19** The auditor should consider whether external confirmation procedures are to be performed as substantive audit procedures. (Ref: par. .A51–.A56)

**.20** The auditor should use external confirmation procedures for accounts receivable, except when one or more of the following is applicable: (Ref: par. .A55)

- a. The overall account balance is immaterial.
- b. External confirmation procedures for accounts receivable would be ineffective. (Ref: par. .A54 and .A56)
- c. 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.

*Substantive Procedures Related to the Financial Statement Closing Process*

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

- a. agreeing or reconciling information in the financial statements with the underlying accounting records, including agreeing or reconciling information in disclosures, whether such information is obtained from within or outside of the general and subsidiary ledgers, and
- b. examining material journal entries and other adjustments made during the course of preparing the financial statements. (Ref: par. .A57)

[As amended, effective for audits of financial statements for periods ending on or after December 15, 2021, by SAS No. 134.]

*Substantive Procedures Responsive to Significant Risks*

**.22** 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. (Ref: par. .A58–.A59)

*Timing of Substantive Procedures*

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

- a. substantive procedures, combined with tests of controls for the intervening period, or
- b. 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. (Ref: par. .A60–.A64)

**.24** 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. See section 240, *Consideration of Fraud in a Financial Statement Audit*.<sup>2</sup> (Ref: par. .A65)

## Selecting Items for Testing to Obtain Audit Evidence

.25 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. (Ref: par. .A66–.A72)

## Adequacy of Presentation of the Financial Statements

.26 The auditor should perform audit procedures to evaluate whether the overall presentation of the financial statements is in accordance with the applicable financial reporting framework. In making this evaluation, the auditor should consider whether the financial statements are presented in a manner that reflects the following:

- a. The appropriate classification and description of financial information and the underlying transactions, events, and conditions
- b. The appropriate presentation, structure, and content of the financial statements (Ref: par. .A73)

[As amended, effective for audits of financial statements for periods ending on or after December 15, 2021, by SAS No. 134.]

## Evaluating the Sufficiency and Appropriateness of Audit Evidence<sup>3</sup>

.27 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. (Ref: par. .A74–.A75)

.28 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. (Ref: par. .A76)

.29 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.<sup>4</sup>

## Documentation

.30 The auditor should include in the audit documentation<sup>5</sup>

- a. 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;

<sup>2</sup> Paragraphs .35–.36 of section 240, *Consideration of Fraud in a Financial Statement Audit*.

<sup>3</sup> See section 700, *Forming an Opinion and Reporting on Financial Statements*.

<sup>4</sup> Paragraphs .08–.10 of section 705, *Modifications to the Opinion in the Independent Auditor's Report*, address qualified, adverse, and disclaimer of opinions.

<sup>5</sup> Paragraphs .08–.12 and .A8 of section 230, *Audit Documentation*.

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- b. the linkage of those procedures with the assessed risks at the relevant assertion level; and
- c. the results of the audit procedures, including the conclusions when such conclusions are not otherwise clear. (Ref: par. .A77)

**.31** 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.

**.32** 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.

**.33** The auditor's documentation should demonstrate that information in the financial statements agrees or reconciles with the underlying accounting records, including agreeing or reconciling disclosures, whether such information is obtained from within or outside of the general and subsidiary ledgers. [As amended, effective for audits of financial statements for periods ending on or after December 15, 2021, by SAS No. 134.]

## Application and Other Explanatory Material

### Overall Responses (Ref: par. .05)

**.A1** Overall responses to address the assessed risks of material misstatement at the financial statement level may include<sup>6</sup>

- 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).

**.A2** 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,

<sup>6</sup> Paragraphs .07–.08 of section 300, *Planning an Audit*, address the auditor's overall audit strategy.



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- obtaining more extensive audit evidence from substantive procedures, and
- increasing the number of locations to be included in the audit scope).

**.A3** Such considerations, therefore, have a significant bearing on the auditor's general approach (for example, an emphasis on substantive procedures [substantive approach] or an approach that uses tests of controls as well as substantive procedures [combined approach]).

## **Audit Procedures Responsive to the Assessed Risks of Material Misstatement at the Relevant Assertion Level**

### ***The Nature, Timing, and Extent of Further Audit Procedures (Ref: par. .06)***

**.A4** 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, in accordance with paragraph .18, 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.

**.A5** 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). See section 500A, *Audit Evidence*, which provides further application guidance about audit procedures.<sup>7</sup> The nature of the audit procedures is most important in responding to the assessed risks.

**.A6** Timing of an audit procedure refers to when it is performed or the period or date to which the audit evidence applies.

**.A7** 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).

**.A8** 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.

<sup>7</sup> Paragraphs .A10–.A26 of section 500A, *Audit Evidence*.

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**.A9** 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<sup>8</sup> or the subjectivity of the account balance.

*Responding to the Assessed Risks at the Assertion Level (Ref: par. .07a)*

**.A10 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.

**.A11** 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, as required by paragraph .08a. 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.

**.A12 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.

**.A13** 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.

**.A14** In addition, certain audit procedures can be performed only at or after the period-end, for example,

- agreeing or reconciling information in the financial statements, including classes of transactions, account balances, and disclosures, with the underlying accounting records including, as applicable,

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<sup>8</sup> The auditor is required by paragraphs .31–.33 of section 240 to perform audit procedures responsive to risks related to management override of controls.

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those relevant accounting records that are outside the general and subsidiary ledgers;

- 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.

[As amended, effective for audits of financial statements for periods ending on or after December 15, 2021, by SAS No. 134.]

**.A15** 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.
- the timing of the preparation of the financial statements, particularly for those disclosures that provide further explanation about amounts recorded in the financial statements.

[As amended, effective for audits of financial statements for periods ending on or after December 15, 2021, by SAS No. 134.]

**.A16 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.

**.A17** 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.

**.A18 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.

**.A19 Considerations specific to smaller, less complex entities.** In the case of smaller entities, the auditor may not identify control activities, or the extent

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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.

*Higher Assessments of Risk (Ref: par. .07b)*

**.A20** 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).

**Tests of Controls**

*Designing and Performing Tests of Controls (Ref: par. .08)*

**.A21** 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.

**.A22** 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.

**.A23** 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.

**.A24** 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.

**.A25** 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.<sup>9</sup> 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, paragraph .08*b* requires the auditor to perform tests of relevant controls.

**.A26** 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. See section 520, *Analytical Procedures*, for further guidance.<sup>10</sup>

*Audit Evidence and Intended Reliance (Ref: par. .09)*

**.A27** 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.

*Nature and Extent of Tests of Controls*

**.A28** *Other audit procedures in combination with inquiry (Ref: par. .10a).* 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.

**.A29** 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.

**.A30** 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.

**.A31** *Extent of tests of controls.* 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

<sup>9</sup> Paragraph .31 of section 315.

<sup>10</sup> Paragraph .A19 of section 520, *Analytical Procedures*.

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- 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. Section 530, *Audit Sampling*, contains further guidance on the extent of testing.

**.A32** 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.

**.A33** *Testing of indirect controls (Ref: par. .10b).* 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.

**.A34** 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.

#### *Timing of Tests of Controls*

**.A35** *Intended period of reliance (Ref: par. .11).* 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.

**.A36** *Using audit evidence obtained during an interim period (Ref: par. .12).* 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

**.A37** 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.

**.A38** *Using audit evidence obtained in previous audits (Ref: par. .13).* 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.

**.A39** *Controls that have changed from previous audits (Ref: par. .14a).* 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.

**.A40** *Controls that have not changed from previous audits (Ref: par. .14b).* 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 by paragraph .14b 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.)

**.A41** In general, the higher the risk of material misstatement or the greater the reliance on controls, the shorter the time period elapsed, if any,

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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

**.A42** 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.

*Evaluating the Operating Effectiveness of Controls (Ref: par. .16-.17)*

**.A43** In accordance with section 265, *Communicating Internal Control Related Matters Identified in an Audit*, 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.<sup>11</sup>

**.A44** 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.

***Substantive Procedures (Ref: par. .18)***

**.A45** Paragraph .18 requires the auditor 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.

*Nature and Extent of Substantive Procedures*

**.A46** 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.

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<sup>11</sup> Paragraph .A11 of section 265, *Communicating Internal Control Related Matters Identified in an Audit*.



## Risk Assessment and Response to Assessed Risks

- A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.

**.A47** Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. Section 520 addresses the application of analytical procedures during an audit.

**.A48** 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.

**.A49** 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.

**.A50** 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. See paragraphs .A66–.A72.

*Considering Whether External Confirmation Procedures Are to Be Performed (Ref: par. .19–.20)*

**.A51** 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

**.A52** Although external confirmations may provide relevant audit evidence relating to certain assertions, some assertions exist for which external

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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.

**.A53** 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.

**.A54** 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.

- The objectivity of the intended confirming party. If the confirming party is a related party of the entity, responses to confirmation requests may be less reliable.

**.A55** For purposes of this section, *accounts receivable* means

- a. the entity's claims against customers that have arisen from the sale of goods or services in the normal course of business; and
- b. a financial institution's loans.

**.A56** 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.

*Substantive Procedures Related to the Financial Statement Closing Process (Ref: par. .21b)*

**.A57** The nature and also the extent of the auditor's substantive procedures related to the financial statement closing process, including testing the appropriateness 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. [As amended, effective for audits of financial statements for periods ending on or after December 15, 2021, by SAS No. 134.]

*Substantive Procedures Responsive to Significant Risks (Ref: par. .22)*

**.A58** Paragraph .22 requires the auditor to perform substantive procedures that are specifically responsive to risks the auditor has determined to be significant risks. Because significant unusual transactions can affect the risks of material misstatement due to error or fraud, substantive procedures that take into account the types of potential misstatements that could result from significant unusual transactions may be necessary, including procedures performed pursuant to paragraph .32 of section 240. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 2021, by SAS No. 135.]

*Timing of Substantive Procedures (Ref: par. .23-.24)*

**.A59** 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. [Paragraph renumbered by the issuance of SAS No. 135, May 2019.]

*Timing of Substantive Procedures (Ref: par. .23-.24)*

**.A60** 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. [Paragraph renumbered by the issuance of SAS No. 135, May 2019.]

**.A61** *Using audit evidence obtained during an interim period (Ref: par. .23).* 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

- a. identify amounts that appear unusual,
- b. investigate any such amounts, and

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- c. perform substantive analytical procedures or tests of details to test the intervening period.

[Paragraph renumbered by the issuance of SAS No. 135, May 2019.]

**.A62** 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

[Paragraph renumbered by the issuance of SAS No. 135, May 2019.]

**.A63** 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. [Paragraph renumbered by the issuance of SAS No. 135, May 2019.]

**.A64** 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)

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- Other causes of significant fluctuations or expected fluctuations that did not occur
- Changes in the composition of the classes of transactions or account balances

[Paragraph renumbered by the issuance of SAS No. 135, May 2019.]

**.A65** *Misstatements detected at an interim date (Ref: par. .24).* When the auditor concludes that the planned nature, timing, or extent of substantive procedures covering the remaining period need to be modified as a result of unexpected misstatements detected at an interim date, such modification may include extending or repeating, at the period-end, the procedures performed at the interim date. [Paragraph renumbered by the issuance of SAS No. 135, May 2019.]

## Selecting Items for Testing to Obtain Audit Evidence (Ref: par. .25)

**.A66** 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 500A to determine the relevance and reliability of information to be used as audit evidence;<sup>12</sup> 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

- a. selecting all items (100 percent examination),
- b. selecting specific items, and
- c. audit sampling.

[Paragraph renumbered by the issuance of SAS No. 135, May 2019.]

**.A67** 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). [Paragraph renumbered by the issuance of SAS No. 135, May 2019.]

## Selecting All Items

**.A68** 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.

[Paragraph renumbered by the issuance of SAS No. 135, May 2019.]

<sup>12</sup> Paragraph .07 of section 500A.

### **Selecting Specific Items**

**.A69** 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.

[Paragraph renumbered by the issuance of SAS No. 135, May 2019.]

**.A70** 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. [Paragraph renumbered by the issuance of SAS No. 135, May 2019.]

### **Audit Sampling**

**.A71** 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. Audit sampling is discussed in section 530. [Paragraph renumbered by the issuance of SAS No. 135, May 2019.]

**.A72** 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. Section 530 addresses planning, performing, and evaluating audit samples. [Paragraph renumbered by the issuance of SAS No. 135, May 2019.]

## **Adequacy of Presentation of the Financial Statements** **(Ref: par. .26)**

**.A73** Evaluating the appropriate presentation, structure, and content of the financial statements includes, for example, consideration of the terminology used as required by the applicable financial reporting framework, the level of detail provided, the aggregation and disaggregation of amounts, and the bases of amounts set forth. [As amended, effective for audits of financial statements for periods ending on or after December 15, 2021, by SAS No. 134. Paragraph renumbered by the issuance of SAS No. 135, May 2019.]

## Evaluating the Sufficiency and Appropriateness of Audit Evidence (Ref: par. .27-.29)

**.A74** 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. Section 315 contains further guidance on revising the auditor's risk assessment.<sup>13</sup> [Paragraph renumbered by the issuance of SAS No. 135, May 2019.]

**.A75** 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. [Paragraph renumbered by the issuance of SAS No. 135, May 2019.]

**.A76** 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 (see section 450, *Evaluation of Misstatements Identified During the Audit*).
- 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.

[Paragraph renumbered by the issuance of SAS No. 135, May 2019.]

<sup>13</sup> Paragraph .32 of section 315.

**Documentation (Ref: par. .30)**

**.A77** 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. [Paragraph renumbered by the issuance of SAS No. 135, May 2019.]

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