



Agenda Item 2B

Appendix—Amendments to Sections in Statement on Auditing Standards No. 122, *Statements on Auditing Standards: Clarification and Recodification, as Amended*

(*Boldface italics* denotes new language. Deleted text is shown in ~~strike through~~.)

1. The amendment to each section in this appendix is effective for audits of financial statements for periods ending on or after December 15, 2023.

AU-C section 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards

[No amendment to paragraphs .01–.07.]

- .08** GAAS contain objectives, requirements, and application and other explanatory material that are designed to support the auditor in obtaining reasonable assurance. GAAS require that the auditor exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit and, among other things,
- *identify* and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, ~~the applicable financial reporting framework, and including~~ *the applicable financial reporting framework, and including* the entity's *system of* internal control.
 - obtain *sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks.*
 - *form an opinion on the financial statements, or determine that an opinion cannot be formed, based on an* evaluation of the audit evidence obtained.

[No amendment to paragraphs .09–.12.]

Definitions

13. For purposes of GAAS, the following terms have the meanings attributed below:

...

Risk of material misstatement. The risk that the financial statements are materially misstated prior to audit. This consists of two components, described as follows at the assertion level: (Ref: Para. A15a)

Inherent risk – The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

Control risk – The risk that a misstatement that could occur in an assertion about a class of transactions, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's ~~internal~~ controls.

[No further amendment to paragraph .013 and amendment to paragraphs .14–.A14.]

Definitions (Ref: Para. 14)

Risk of Material Misstatement

A15. For the purposes of the GAAs, a risk of material misstatement exists when:

- a. *There is a reasonable possibility of a misstatement occurring (i.e., its likelihood); and*
- b. *If it were to occur, there is a reasonable possibility of the misstatement being material (that is, its magnitude).*

[No amendment to paragraphs .A15–.A41.]

[Paragraphs .A15–.A44 are renumbered as .A16–.A45.]

~~A42.A43~~ Inherent risk is ***influenced by inherent risk factors***. ~~higher for some assertions and related classes of transactions, account balances, and disclosures than for others.~~ ***Depending on the degree to which the inherent risk factors affect the susceptibility to misstatement of an assertion, the level of inherent risk varies on a scale that is referred to as the spectrum of inherent risk. The auditor determines significant classes of transactions, account balances and disclosures, and their relevant assertions, as part of the process of identifying and assessing the risks of material misstatement.***

For example, it may be higher for complex calculations or for accounts ***balances*** consisting of amounts derived from accounting estimates that are subject to significant estimation uncertainty ***may be identified as significant account balances, and the***

auditor's assessment of inherent risk for the related risks at the assertion level may be higher because of the high estimation uncertainty. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement. Factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may also influence the inherent risk related to a specific assertion. Such factors may include, for example, a lack of sufficient working capital to continue operations or a declining industry characterized by a large number of business failures.

~~A43.~~ **A44** Control risk is a function of the effectiveness of the design, implementation, and maintenance of ~~internal~~ controls by management to address identified risks that threaten the achievement of the entity's objectives relevant to preparation and fair presentation of the entity's financial statements. However, internal control, no matter how well designed and operated, can only reduce, but not eliminate, risks of material misstatement in the financial statements, because of the inherent limitations of ~~internal~~ controls. These include, for example, the possibility of human errors or mistakes, or of controls being circumvented by collusion or inappropriate management override. Accordingly, some control risk will always exist. GAAS provide the conditions under which the auditor is required to, or may choose to, test the operating effectiveness of controls in determining the nature, timing, and extent of substantive procedures to be performed. ^{fn 14}

^{fn 14} [Footnote omitted for purposes of this proposed SAS.]

[No amendment to paragraph .A44.]

~~.A44~~ **A45.** GAAS *typically do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the risks of material misstatement rather than inherent risk and control risk separately.* However, *AU-C section 315 requires inherent risk to be assessed separately from control risk to provide a basis for designing and performing audit procedures to respond to the assessed risks of material misstatement at the assertion level.* ~~the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations.~~ The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages or in nonquantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

A45. Risks of material misstatement are assessed at the assertion level in order to determine the nature, timing and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. ^{FN 15}

^{fn 15} AU-C section 330, paragraph 6.

[Paragraphs A45.–A67 are renumbered as A46. –A68. Subsequent footnotes renumbered.]

[No amendment to paragraphs .A45–.A63.]

~~A64~~ **A65.** When necessary, the application and other explanatory material provides further explanation of the requirements of an AU-C section and guidance for carrying them out.

- In particular, it may explain more precisely what a requirement means or is intended to cover, *including in some AU-Cs, such as AU-C section 315, why a procedure is required.*
- Include examples of procedures that may be appropriate in the circumstances.

Although such guidance does not in itself impose a requirement, it is relevant to the proper application of the requirements of an AU-C section. The auditor is required by [paragraph .21](#) to understand the application and other explanatory material; how the auditor applies the guidance in the engagement depends on the exercise of professional judgment in the circumstances consistent with the objective of the AU-C section. The words "may," "might," and "could" are used to describe these actions and procedures. The application and other explanatory material may also provide background information on matters addressed in an AU-C section.

[No amendment to paragraphs .A64–.A68.]

~~Considerations Specific to Smaller, Less Complex Entities~~ **Scalability Considerations**

A70. *Scalability considerations have been included in some AU-C sections (AU-C Section 315), illustrating the application of the requirements to all entities whose regardless of whether their nature and circumstances are less complex, as well as those that are or more complex. Less complex entities are entities for which the characteristics in paragraph A66 apply.*

[Paragraphs A69.–A85 are renumbered as A71. –A88.]

~~A69~~ **A71.** For purposes of specifying additional considerations to audits of smaller, less complex entities, a *smaller, less complex entity* refers to an entity that typically possesses qualitative characteristics, such as the following:

- a. Concentration of ownership and management in a small number of individuals;
and
- b. One or more of the following:
 - i. Straightforward or uncomplicated transactions
 - ii. Simple record keeping
 - iii. Few lines of business and few products within business lines

- iv. ***Simpler systems of Few*** internal controls
- v. Few levels of management with responsibility for a broad range of controls
- vi. Few personnel, many having a wide range of duties

These qualitative characteristics are not exhaustive, they are not exclusive to smaller, less complex entities, and smaller, less complex entities do not necessarily display all of these characteristics.

Considerations Specific to Automated Tools and Techniques

A72. The considerations specific to “automated tools and techniques” included in some AU-C section sections (for example, AU-C section 315) have been developed to explain how the auditor may apply certain requirements when using automated tools and techniques in performing audit procedures.

[No further amendment to AU-C section 200.]

AU-C section 210, Terms of the Engagement

[No amendment to paragraphs .01–.A15.]

.A16 Management has the responsibility to determine what internal control is necessary to enable the preparation and fair presentation of the financial statements. The term *internal control* encompasses a wide range of activities within components ***of the system of internal control*** that may be described as the control environment; the entity’s risk assessment process; ***the entity’s process to monitor the system of internal control***, the information system, ~~including the related business processes relevant to financial reporting~~, and communication; ***and*** control activities; ~~and monitoring of controls~~. This division, however, does not necessarily reflect how a particular entity may design, implement, and maintain its internal control or how it may classify any particular component.^{fn 9} An entity’s internal control will reflect the needs of management, the complexity of the business, the nature of the risks to which the entity is subject, and relevant laws or regulations.

^{fn 9} [Footnote omitted for purposes of this proposed SAS.]

[No further amendment to section 210.]

AU-C section 230, Audit Documentation

[No amendment to paragraphs .01–.A19.]

.A20 When preparing audit documentation, the auditor of a smaller, less complex entity may also find it helpful and efficient to record various aspects of the audit together in a single document, with cross-references to supporting working papers as appropriate. Examples of matters that may be documented together in the audit of a smaller, less complex entity include the understanding of the entity and its *its environment, the applicable financial reporting framework, and the entity's system of* internal control; the overall audit strategy and audit plan; materiality; assessed risks, significant findings or issues noted during the audit; and conclusions reached.

[No further amendment to AU-C section 230.]

AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*

[No amendment to paragraphs .01–.06.]

.07 Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information, or override controls ~~procedures~~ designed to prevent similar frauds by other employees.

[No amendment to paragraphs .08–.15.]

.16 When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, *the applicable financial reporting framework and including* the entity's *system of* internal control, required by section 315, the auditor should perform the procedures in paragraphs .17–.24 to obtain information for use in identifying the risks of material misstatement due to fraud.^{fn 5}

^{fn 5} [Footnote omitted for purposes of this proposed SAS.]

Those Charged with Governance

.20 Unless all of those charged with governance are involved in managing the entity,^{fn 7} the auditor should obtain an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the ~~internal~~ controls that management has established to mitigate these risks. (Ref: par. .A21–.A23)

^{fn 7} [Footnote omitted for purposes of this proposed SAS.]

[No amendment to paragraphs .21–.26.]

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.27 The auditor should treat those assessed risks of material misstatement due to fraud as significant risks and, accordingly, to the extent not already done so, the auditor should ~~obtain an understanding of the entity's related control activities, relevant to~~ **identify the entity's controls, including control activities, relevant to that address such risks and evaluate their design and determine whether they have been implemented** ~~including the evaluation of whether such controls have been suitably designed and implemented to mitigate such fraud risks.~~
^{fn 10} (Ref: par. .A36-.A37)

^{fn 10} Proposed SAS, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement, paragraphs 26a.i. and 26d.

[No amendment to paragraphs .28-.42. Subsequent footnotes renumbered.]

.43 The auditor should include in the audit documentation ^{fn 13} ~~of the auditor's understanding of the entity and its environment~~ **the identification** and the assessment of the risks of material misstatement required by section 315 the following ^{fn 14}

- a. The significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud, and how and when the discussion occurred and the audit team members who participated
- b. The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level (See paragraphs .16-.27.)
- c. **Identified controls in the control activities component that address assessed risks of material misstatement due to fraud.**

^{fn 13} and ^{fn 14} [Footnotes omitted for purposes of this proposed SAS.]

[No amendment to paragraphs .44-.A8.]

Professional Skepticism (Ref: Para. 12-14)

.A9 Maintaining professional skepticism requires an ongoing questioning of whether the information and audit evidence obtained suggests that a material misstatement due to fraud may exist. It includes considering the reliability of the information to be used as audit evidence and ~~the identified controls in the control activities, if any, over its preparation and maintenance when relevant.~~ **the identified controls in the control activities, if any, over its preparation and maintenance**. Due to the characteristics of fraud, the auditor's professional skepticism is particularly important when considering the risks of material misstatement due to fraud.

[No amendment to paragraphs .A10-.A20.]

.A21 Those charged with governance of an entity oversee the entity's systems for monitoring risk, financial control, and compliance with the law. In some circumstances, governance practices are well developed, and those charged with governance play an active role in oversight of the entity's assessment of the risks of fraud and ~~of the relevant~~

~~internal control~~ **the controls that address such risks**. Because the responsibilities of those charged with governance and management may vary by entity, it is important that the auditor understands the respective responsibilities of those charged with governance and management to enable the auditor to obtain an understanding of the oversight exercised by the appropriate individuals.^{fn 18}

^{fn 18} [Footnote omitted for purposes of this proposed SAS.]

.A22 An understanding of the oversight exercised by those charged with governance may provide insights regarding the susceptibility of the entity to management fraud, the adequacy of ~~internal controls~~ **that address over** risks of fraud, and the competency and integrity of management. The auditor may obtain this understanding in a number of ways, such as by attending meetings during which such discussions take place, reading the minutes from such meetings, or making inquiries of those charged with governance.

[No amendment to paragraphs .A23–.A26.]

.A27 In addition to information obtained from applying analytical procedures, other information obtained about the entity and its environment, **the applicable financial reporting framework and the entity's system of internal control** may be helpful in identifying the risks of material misstatement due to fraud. The discussion among team members may provide information that is helpful in identifying such risks. In addition, information obtained from the auditor's client acceptance and retention processes, and experience gained on other engagements performed for the entity, for example, engagements to review interim financial information, may be relevant in the identification of the risks of material misstatement due to fraud.

.A30 Examples of fraud risk factors related to fraudulent financial reporting and misappropriation of assets are presented in appendix A, "Examples of Fraud Risk Factors." These illustrative risk factors are classified based on the three conditions that are generally present when fraud exists:

- An incentive or pressure to commit fraud
- A perceived opportunity to commit fraud
- An ability to rationalize the fraudulent action

The inability to observe one or more of these conditions does not necessarily mean that no risk of material misstatement due to fraud exists.

Fraud risk factors may related to incentives, pressures or opportunities ~~may~~ that arise from conditions that create susceptibility to misstatement, before consideration of controls. Fraud risk factors, which includes intentional management bias, are insofar as they affect inherent risk, inherent risk factors. Fraud risk factors may also relate to conditions within the entity's system of internal control that provide opportunity to commit fraud or that may affect management's attitude or ability to rationalize

fraudulent actions. Fraud risk factors reflective of an attitude that permits rationalization of the fraudulent action may not be susceptible to observation by the auditor. Nevertheless, the auditor may become aware of the existence of such information **through, for example, the required understanding of the entity's control environment.**^{fn}

²⁰ Although the fraud risk factors described in appendix A cover a broad range of situations that may be faced by auditors, they are only examples and other risk factors may exist.

^{fn 20} Proposed SAS, paragraph 28.

[No amendment to paragraphs .A31–.A36. Subsequent footnotes renumbered.]

.A37 It is, therefore, important for the auditor to obtain an understanding of the controls that management has designed, implemented, and maintained to prevent and detect fraud. ~~In doing so,~~ **In identifying the controls that address the risks of material misstatement due to fraud,** the auditor may learn, for example, that management has consciously chosen to accept the risks associated with a lack of segregation of duties. Information from ~~obtaining this understanding~~ **identifying these controls, and evaluating their design and determining whether they have been implemented** may also be useful in identifying fraud risks factors that may affect the auditor's assessment of the risks that the financial statements may contain material misstatement due to fraud.

[No amendment to paragraphs .A38–.A48.]

.A49 When identifying and selecting journal entries and other adjustments for testing and determining the appropriate method of examining the underlying support for the items selected, the following matters may be relevant:

- **The identification and assessment of the risks of material misstatement due to fraud.** The presence of fraud risk factors and other information obtained during the auditor's identification and assessment of the risks of material misstatement due to fraud may assist the auditor to identify specific classes of journal entries and other adjustments for testing.
- **Controls that have been implemented over journal entries and other adjustments.** Effective controls over the preparation and posting of journal entries and other adjustments may reduce the extent of substantive testing necessary, provided that the auditor has tested the operating effectiveness of the controls.
- **The entity's financial reporting process and the nature of evidence that can be obtained.** For many entities, routine processing of transactions involves a combination of manual and automated steps and procedures controls. Similarly, the processing of journal entries and other adjustments may involve both manual and automated procedures and controls. When IT is used in the financial reporting process, journal entries and other adjustments may exist only in electronic form.

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- *The characteristics of fraudulent journal entries or other adjustments.* Inappropriate journal entries or other adjustments often have unique identifying characteristics. Such characteristics may include entries (a) made to unrelated, unusual, or seldom-used accounts; (b) made by individuals who typically do not make journal entries; (c) recorded at the end of the period or as postclosing entries that have little or no explanation or description; (d) made either before or during the preparation of the financial statements that do not have account numbers; or (e) containing round numbers or consistent ending numbers.
- *The nature and complexity of the accounts.* Inappropriate journal entries or adjustments may be applied to accounts that (a) contain transactions that are complex or unusual in nature, (b) contain significant estimates and period-end adjustments, (c) have been prone to misstatements in the past, (d) have not been reconciled on a timely basis or contain unreconciled differences, (e) contain intercompany transactions, or (f) are otherwise associated with an identified risk of material misstatement due to fraud. In audits of entities that have several locations or components, consideration is given to the need to select journal entries from multiple locations.
- Journal entries or other adjustments processed outside the normal course of *business*. Nonstandard journal entries, and other entries such as consolidating adjustments, may not be subject to the same ~~level of internal~~ **nature and extent of controls** as those journal entries used on a recurring basis to record transactions such as monthly sales, purchases, and cash disbursements.

[No amendment to paragraphs .A50–.A74.]

Appendix A — Examples of Fraud Risk Factors (Ref: par. .11, .24, and .A30)

.A75

The fraud risk factors identified in this appendix are examples of such factors that may be faced by auditors in a broad range of situations. Separately presented are examples relating to the two types of fraud relevant to the auditor’s consideration—that is, fraudulent financial reporting and misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: (a) incentives and pressures, (b) opportunities, and (c) attitudes and rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may identify additional or different risk factors. Not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size or with different ownership characteristics or circumstances. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Fraud risk factors may relate to incentives or pressures, or opportunities that arise from conditions that create susceptibility to misstatement before consideration of controls (that is, the inherent risk). Such factors are inherent risk factors, and may be due to susceptibility to management bias. Fraud risk factors related to opportunities may also arise from other identified inherent risk factors (for example, complexity or uncertainty may create opportunities that result in susceptibility to misstatement due to fraud). Fraud risk factors related to opportunities may also relate to conditions within the entity's system of internal control, such as limitations or deficiencies in the entity's internal control that create such opportunities. Fraud risk factors related to attitudes or rationalizations may arise, in particular, from limitations or deficiencies in the entity's control environment.

Risk Factors Relating to Misstatements Arising From Fraudulent Financial Reporting

The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting.

Incentives and Pressures

Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by) the following:

- High degree of competition or market saturation, accompanied by declining margins
- High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates
- Significant declines in customer demand and increasing business failures in either the industry or overall economy
- Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent
- Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth
- Rapid growth or unusual profitability especially compared to that of other companies in the same industry
- New accounting, statutory, or regulatory requirements

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- Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:
- Profitability or trend level expectations of investment analysts, institutional investors, significant creditors, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management in, for example, overly optimistic press releases or annual report messages
- Need to obtain additional debt or equity financing to stay competitive—including financing of major research and development or capital expenditures
- Marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements
- Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards
- A need to achieve financial targets required in bond covenants
- Pressure for management to meet the expectations of legislative or oversight bodies or to achieve political outcomes, or both

Information available indicates that the personal financial situation of management or those charged with governance is threatened by the entity's financial performance arising from the following:

- Significant financial interests in the entity
- Significant portions of their compensation (for example, bonuses, stock options, and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow^{fn1}
- Personal guarantees of debts of the entity

Management or operating personnel are under excessive pressure to meet financial targets established by those charged with governance, including sales or profitability incentive goals.

^{fn 1} [Footnote omitted for purposes of this proposed SAS]

Opportunities

The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:

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- Significant related party transactions not in the ordinary course of business or with related entities not audited or audited by another firm
- A strong financial presence or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's-length transactions
- Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate
- Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions
- Significant operations located or conducted across jurisdictional borders where differing business environments and regulations exist
- Use of business intermediaries for which there appears to be no clear business justification
- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification

The monitoring of management is not effective as a result of the following:

- Domination of management by a single person or small group (in a nonowner-managed business) without compensating controls.
- Oversight by those charged with governance over the financial reporting process and internal control is not effective.

The organizational structure is complex or unstable, as evidenced by the following:

- Difficulty in determining the organization or individuals that have controlling interest in the entity
- Overly complex organizational structure involving unusual legal entities or managerial lines of authority
- High turnover of senior management, legal counsel, or those charged with governance

~~Internal control components are deficient~~ **Deficiencies in internal control** as a result of the following:

- Inadequate monitoring of controls process to monitor the entity's system of internal control, including automated controls and controls over interim financial reporting (when external reporting is required)

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- High turnover rates or employment of staff in accounting, IT, or the internal audit function who are not effective
- Accounting and information systems that are not effective, including situations involving significant deficiencies or material weaknesses in internal control
- Weak controls over budget preparation and development and compliance with law or regulation.

Attitudes and Rationalizations

- Communication, implementation, support, or enforcement of the entity's values or ethical standards by management, or the communication of inappropriate values or ethical standards that are not effective.
- Nonfinancial management's excessive participation in or preoccupation with the selection of accounting policies or the determination of significant estimates.
- Known history of violations of securities law or other law or regulation, or claims against the entity, its senior management, or those charged with governance alleging fraud or violations of law or regulation.
- Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend.
- The practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts.
- Management failing to remedy known significant deficiencies or material weaknesses in internal control on a timely basis.
- An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons.
- Low morale among senior management.
- The owner-manager makes no distinction between personal and business transactions.
- Dispute between shareholders in a closely held entity.
- Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality.
- A strained relationship between management and the current or predecessor auditor, as exhibited by the following:

- Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters
- Unreasonable demands on the auditor, such as unrealistic time constraints regarding the completion of the audit or the issuance of the auditor's report
- Restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with those charged with governance
- Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement

Risk Factors Arising From Misstatements Arising From Misappropriation of Assets

Risk factors that relate to misstatements arising from misappropriation of assets are also classified according to the three conditions generally present when fraud exists: incentives and pressures, opportunities, and attitudes and rationalization. Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present when misstatements arising from misappropriation of assets occur. For example, ineffective monitoring of management and other deficiencies in internal control that are not effective may be present when misstatements due to either fraudulent financial reporting or misappropriation of assets exist. The following are examples of risk factors related to misstatements arising from misappropriation of assets.

Incentives and Pressures

Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.

Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:

- Known or anticipated future employee layoffs
- Recent or anticipated changes to employee compensation or benefit plans
- Promotions, compensation, or other rewards inconsistent with expectations

Opportunities

Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when the following exist:

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- Large amounts of cash on hand or processed
- Inventory items that are small in size, of high value, or in high demand
- Easily convertible assets, such as bearer bonds, diamonds, or computer chips
- Fixed assets that are small in size, marketable, or lack observable identification of ownership

Inadequate ~~internal~~ controls over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because the following exist:

- Inadequate segregation of duties or independent checks
- Inadequate oversight of senior management expenditures, such as travel and other reimbursements
- Inadequate management oversight of employees responsible for assets (for example, inadequate supervision or monitoring of remote locations)
- Inadequate job applicant screening of employees with access to assets
- Inadequate record keeping with respect to assets
- Inadequate system of authorization and approval of transactions (for example, in purchasing)
- Inadequate physical safeguards over cash, investments, inventory, or fixed assets
- Lack of complete and timely reconciliations of assets
- Lack of timely and appropriate documentation of transactions (for example, credits for merchandise returns)
- Lack of mandatory vacations for employees performing key control functions
- Inadequate management understanding of IT, which enables IT employees to perpetrate a misappropriation
- Inadequate access controls over automated records, including controls over and review of computer systems event logs

Attitudes and Rationalizations

- Disregard for the need for monitoring or reducing risks related to misappropriations of assets

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- Disregard for internal controls over misappropriation of assets by overriding existing controls or by failing to take appropriate remedial action on known deficiencies in internal control
- Behavior indicating displeasure or dissatisfaction with the entity or its treatment of the employee
- Changes in behavior or lifestyle that may indicate assets have been misappropriated
- The belief by some government or other officials that their level of authority justifies a certain level of compensation and personal privileges
- Tolerance of petty theft

Appendix B — Examples of Possible Audit Procedures to Address the Assessed Risks of Material Misstatement Due to Fraud (Ref: [par. .22](#) and [.A46](#))

.A76

The following are examples of possible audit procedures to address the assessed risks of material misstatement due to fraud resulting from both fraudulent financial reporting and misappropriation of assets. Although these procedures cover a broad range of situations, they are only examples and, accordingly, they may not be the most appropriate nor necessary in each circumstance. Also the order of the procedures provided is not intended to reflect their relative importance.

Consideration at the Assertion Level

Specific responses to the auditor's assessment of the risks of material misstatement due to fraud will vary depending upon the types or combinations of fraud risk factors or conditions identified, and the classes of transactions, account balances, disclosures, and assertions they may affect.

The following are specific examples of responses:

- Visiting locations or performing certain tests on a surprise or unannounced basis (for example, observing inventory at locations where auditor attendance has not been previously announced or counting cash at a particular date on a surprise basis)
- Requesting that inventories be counted at the end of the reporting period or on a date closer to period end to minimize the risk of manipulation of balances in the period between the date of completion of the count and the end of the reporting period

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- Altering the audit approach in the current year (for example, contacting major customers and suppliers orally in addition to sending written confirmation, sending confirmation requests to a specific party within an organization, or seeking more or different information)
- Performing a detailed review of the entity's quarter-end or year-end adjusting entries and investigating any that appear to have an unusual nature or amount
- For significant and unusual transactions, particularly those occurring at or near year end, investigating the possibility of related parties and the sources of financial resources supporting the transactions
- Performing substantive analytical procedures using disaggregated data (for example, comparing sales and cost of sales by location, line of business, or month to expectations developed by the auditor)
- Conducting interviews of personnel involved in areas in which a risk of material misstatement due to fraud has been identified, to obtain their insights about the risk, and whether, or how, controls address the risk
- When other independent auditors are auditing the financial statements of one or more subsidiaries, divisions, or branches, discussing with them the extent of work necessary to be performed to address the assessed risk of material misstatement due to fraud resulting from transactions and activities among these components
- If the work of an expert a specialist becomes particularly significant with respect to a financial statement item for which the assessed risk of material misstatement due to fraud is high, performing additional procedures relating to some or all of the expert's assumptions, methods, or findings to determine that the findings are not unreasonable, or engaging another expert for that purpose
- Performing audit procedures to analyze selected opening balance sheet accounts of previously audited financial statements to assess how certain issues involving accounting estimates and judgments, for example, an allowance for sales returns, were resolved with the benefit of hindsight
- Performing procedures on account or other reconciliations prepared by the entity, including considering reconciliations performed at interim periods
- Performing computer-assisted techniques, such as data mining to test for anomalies in a population
- Testing the integrity of computer-produced records and transactions
- Seeking additional audit evidence from sources outside of the entity being audited

Specific Responses—Misstatement Resulting From Fraudulent Financial Reporting

Examples of responses to the auditor's assessment of the risks of material misstatement due to fraudulent financial reporting are as follows:

Revenue Recognition

- Performing substantive analytical procedures relating to revenue using disaggregated data; for example, comparing revenue reported by month and by product line or business segment during the current reporting period with comparable prior periods or with revenue related to cash collections (computer-assisted audit techniques may be useful in identifying unusual or unexpected revenue relationships or transactions)
- Confirming with customers certain relevant contract terms and the absence of side agreements because the appropriate accounting often is influenced by such terms or agreements and basis for rebates or the period to which they relate are often poorly documented (for example, acceptance criteria, delivery and payment terms, the absence of future or continuing vendor obligations, the right to return the product, guaranteed resale amounts, and cancellation or refund provisions often are relevant in such circumstances)
- Inquiring of the entity's sales and marketing personnel or in-house legal counsel regarding sales or shipments near the end of the period and their knowledge of any unusual terms or conditions associated with these transactions
- Being physically present at one or more locations at period end to observe goods being shipped or being readied for shipment (or returns awaiting processing) and performing other appropriate sales and inventory cutoff procedures
- For those situations for which revenue transactions are electronically initiated, processed, and recorded, testing controls to determine whether they provide assurance that recorded revenue transactions occurred and are properly recorded

Inventory Quantities

- Examining the entity's inventory records to identify locations or items that require specific attention during or after the physical inventory count
- Observing inventory counts at certain locations on an unannounced basis or conducting inventory counts at all locations on the same date
- Conducting inventory counts at or near the end of the reporting period to minimize the risk of inappropriate manipulation during the period between the count and the end of the reporting period
- Performing additional procedures during the observation of the count; for example, more rigorously examining the contents of boxed items, the manner in which the goods are stacked (for example, hollow squares) or labeled, and the

quality (that is, purity, grade, or concentration) of liquid substances such as perfumes or specialty chemicals (using the work of an expert may be helpful in this regard)

- Comparing the quantities for the current period with prior periods by class or category of inventory, location or other criteria, or comparison of quantities counted with perpetual records
- Using computer-assisted audit techniques to further test the compilation of the physical inventory counts (for example, sorting by tag number to test tag controls or by item serial number to test the possibility of item omission or duplication)

Management Estimates

- Using an expert to develop an independent estimate for comparison to management's estimate
- Extending inquiries to individuals outside of management and the accounting department to corroborate management's ability and intent to carry out plans that are relevant to developing the estimate

Specific Responses—Misstatements Due to Misappropriation of Assets

Differing circumstances would necessarily dictate different responses. Ordinarily, the audit response to an assessed risk of material misstatement due to fraud relating to misappropriation of assets will be directed toward certain account balances and classes of transactions. Although some of the audit responses noted in the preceding two categories may apply in such circumstances, the scope of the work is to be linked to the specific information about the misappropriation risk that has been identified.

Examples of responses to the auditor's assessment of the risk of material misstatements due to misappropriation of assets are as follows:

- Counting cash or securities at or near year end
- Confirming directly with customers the account activity (including credit memo and sales return activity as well as dates payments were made) for the period under audit
- Analyzing recoveries of written-off accounts
- Analyzing inventory shortages by location or product type
- Comparing key inventory ratios to industry norm
- Reviewing supporting documentation for reductions to the perpetual inventory records

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- Performing a computerized match of the vendor list with a list of employees to identify matches of addresses or phone numbers
- Performing a computerized search of payroll records to identify duplicate addresses, employee identification or taxing authority numbers, or bank accounts
- Reviewing personnel files for those that contain little or no evidence of activity; for example, lack of performance evaluations
- Analyzing sales discounts and returns for unusual patterns or trends
- Confirming specific terms of contracts with third parties
- Obtaining evidence that contracts are being carried out in accordance with their terms
- Reviewing the propriety of large and unusual expenses
- Reviewing the authorization and carrying value of senior management and related party loans
- Reviewing the level and propriety of expense reports submitted by senior management

[[No further amendment to section 240.]

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AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*

[No amendment to paragraphs .01–.A23.]

Evaluating the Implications of Noncompliance (Ref: [par. .20](#))

.A24 As required by [paragraph .20](#), the auditor evaluates the implications of noncompliance with regard to other aspects of the audit, including the auditor's risk assessment and the reliability of written representations. The implications of particular instances of noncompliance identified by the auditor will depend on the relationship of the perpetration and concealment, if any, of the act to specific controls activities and the level of management or employees involved, especially implications arising from the involvement of the highest authority within the entity

[No further amendment to AU-C section 250.]

AU-C section 260, *The Auditor's Communication With Those Charged With Governance*

[No amendment to paragraphs .01–.A19.]

.A20 Communicating significant risks identified by the auditor helps those charged with governance understand those matters and why they *were determined to be significant risks* ~~require special audit consideration~~. The communication about significant risks may assist those charged with governance in fulfilling their responsibility to oversee the financial reporting process. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 2021, by SAS No. 134.]

.A21 Other matters regarding the planned scope and timing of the audit may include the following:

- How the auditor plans to address the significant risks of material misstatement, whether due to fraud or error
- How the auditor plans to address areas of higher assessed risks of material misstatement.
- The auditor's approach to *the system of* internal control. ~~relevant to the audit~~ including, when applicable, whether the auditor will express an opinion on the effectiveness of internal control over financial reporting.
- ...

[No further amendment to AU-C section 250.]

AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit*

.01 This section addresses the auditor's responsibility to appropriately communicate to those charged with governance and management deficiencies in *the entity's system of* internal control that the auditor has identified in an audit of financial statements. This section does not impose additional responsibilities on the auditor regarding obtaining an understanding of internal control or designing and performing tests of controls over and above the requirements of section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, and section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*. [Section 260, *The Auditor's Communication With Those Charged With Governance*](#),

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establishes further requirements and provides guidance regarding the auditor's responsibility to communicate with those charged with governance regarding the audit.

.02 The auditor is required to obtain an understanding of *the entity's system of* internal control relevant to the audit when identifying and assessing the risks of material misstatement.^{fn 1} In making those risk assessments, the auditor considers *the entity's system of* internal control in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of internal control. The auditor may identify *control* deficiencies ~~in internal control~~, not only during this risk assessment process but also at any other stage of the audit. This section specifies which identified deficiencies the auditor is required to communicate to those charged with governance and management.

Commented [HH1]: Not in the ISA but sounds repetitive.

^{fn 1} [Footnote omitted for purposes of this proposed SAS. Subsequent footnotes renumbered.]

[No amendment to paragraphs .03--A2.]

.A3 Although the concepts underlying *controls in the* control activities component in smaller entities are likely to be similar to those in larger entities, the formality with which controls operate will vary. Further, smaller entities may find that certain types of controls ~~activities~~ are not necessary because of controls applied by management. For example, management's sole authority for granting credit to customers and approving significant purchases can provide effective control over important account balances and transactions, lessening or removing the need for more detailed controls ~~activities~~.

[No amendment to paragraphs .03--A9.]

.A10 Controls may be designed to operate individually, or in combination, to effectively prevent, or detect and correct, misstatements.^{fn 3} For example, controls over accounts receivable may consist of both automated and manual controls designed to operate together to prevent, or detect and correct, misstatements in the account balance. A deficiency in internal control on its own may not be sufficiently important to constitute a significant deficiency or a material weakness. However, a combination of deficiencies affecting the same class of transactions, account balance, or disclosure, relevant assertion, or component of *entity's system of* internal control may increase the risks of misstatement to such an extent to give rise to a significant deficiency or material weakness. [As amended, effective for audits for periods ending on or after December 15, 2016, by SAS No. 130.]

^{fn 3} [Footnote omitted for purposes of this proposed SAS.]

[No further amendment to AU-C section 265.]

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

[No amendment to paragraphs .01–.07.]

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

.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 **significant** class of transactions, account balance, and disclosure, including
 - i. the likelihood **and magnitude** of material misstatement due to the particular characteristics of the ~~relevant~~ **significant** class of transactions, account balance, or disclosure (the inherent risk) and
 - ii. whether the risk assessment takes account of ~~relevant~~ controls **that address the risk of material misstatement** (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~~ **plans to test** 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~~ **plans to test** 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)

[No amendment to paragraph .09.]

.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

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- 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. **To the extent not already addressed**, 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)

[No amendment to paragraphs 11.–12.]

.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~~ **components of the entity's system of** internal control, including the control environment, the entity's **process to monitoring of the system of internal** 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;
- 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)

Controls Over Significant Risks

.15 If the auditor ~~plans~~ **intends** to rely on controls over a risk the auditor has determined to be a significant risk, ^{fn 1} the auditor should test the operating effectiveness of those controls in the current period.

^{fn 1} [Footnote omitted for purposes of this proposed SAS.]

Evaluating the Operating Effectiveness of Controls

.16 When evaluating the operating effectiveness of ~~relevant~~ controls ***upon which the auditor intends to rely***, 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 ***material*** misstatement need to be addressed using substantive procedures. (Ref: par. .A44)

18 ~~Irrespective of the assessed risks of material misstatement, T~~he auditor should ~~design and perform~~ perform substantive procedures for ***each*** all relevant assertions ~~related of to~~ each ***material significant*** class of transactions, account balance, and disclosure, ***regardless of the assessed level of control risk***. (Ref: [par. .A45-.A50](#))

[No amendment to paragraphs .19 -.28.]

.29 If the auditor has not obtained sufficient appropriate audit evidence ~~about~~ ***related to a relevant assertion about a significant class of transactions, account balance or disclosure***, 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. ^{fn 4}

^{fn 4} [Footnote omitted for purposes of this proposed SAS.]

[No amendment to paragraphs .30-.33.]

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 ^{fn 6}

- emphasizing to the audit team the need to maintain professional skepticism.
- assigning more experienced staff or those with specialized skills or using specialists.

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- providing ~~more supervision~~ **changes to the nature, timing and extent of direction and supervision of members of the engagement team and the review of the work performed.**
- incorporating additional elements of unpredictability in the selection of further audit procedures to be performed.
- **Changes to the overall audit strategy as required by AU-C section 300, or planned audit procedures, and may include changes to:**
 - **The auditor's determination of performance materiality in accordance with AU-C section 320.**
 - **The auditor's plans to tests the operating effectiveness of controls, and the persuasiveness of audit evidence needed to support the planned reliance on the operating effectiveness of the controls, particularly when deficiencies in the control environment or the entity's monitoring activities are identified.**
 - **The nature, timing and extent of substantive procedures. For example, it may be appropriate to perform substantive procedures at or near the date of the financial statements when the risk of material misstatement is assessed as higher.**
 - ~~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).~~

^{in 6} [Footnote omitted for purposes of this proposed SAS.]

[No amendment to paragraphs .A2–.A3.]

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

The Nature, Timing and Extent of Further Audit Procedures (Ref: Para. 6)

.A4The auditor's assessment of the identified risks *of material misstatement* 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

- a. 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.

- b. performing only substantive procedures is appropriate for particular assertions, and therefore, the auditor excludes the effect of controls from the ~~relevant risk~~ assessment **of the risk of material misstatement**. This may be because the ~~auditor's risk assessment procedures have not identified any effective controls relevant to the assertion or because~~ **auditor has not identified a risk for which substantive procedures alone cannot provide sufficient appropriate audit evidence and therefore is not required to test the operating effectiveness of controls** ~~testing controls would be inefficient, and~~ ~~Therefore, the auditor does not intend to rely on~~ **may not plan to test** the operating effectiveness of controls in determining the nature, timing, and extent of substantive procedures.
- c. a combined approach using both tests of controls and substantive procedures is an effective approach.

[No amendment to paragraphs .A5–.A6.]

.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~~).

[No amendment to paragraph .A8.]

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

.A10 *AU-C section 315 requires that the auditor's assessment of the risks of material misstatement at the assertion level is performed by assessing inherent risk and control risk. The auditor assesses inherent risk by assessing the likelihood and magnitude of a ~~material~~ misstatement taking into account how, and the degree to which the inherent risk factors affect the susceptibility to misstatement of relevant assertions, ~~identified events or conditions relating to significant classes of transactions, account balances or disclosures are subject to, or affected by, the inherent risk factors.~~^{fn 9}The auditor's assessed risks, **including the reasons for those assessed risks**, may affect both the types of audit procedures to be performed and their combination. For example, when an assessed risk is higher, 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 **material** misstatement of the completeness assertion, whereas substantive procedures may be most responsive to the assessed risk of **material** misstatement of the occurrence assertion.*

^{fn 9} *AU-C section 315, paragraph 48*

[Subsequent footnotes renumbered.]

.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~~ ***the auditor plans to test the operating effectiveness of*** 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.

[No amendment to paragraphs .A12--A18.]

.A19 *Considerations specific to smaller, less complex entities.* In the case of smaller entities, the auditor may not identify controls ~~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 controls ~~activities~~ or other components of ***of the system of internal*** control may make it impossible to obtain sufficient appropriate audit evidence.

[No amendment to paragraph .A20.]

Higher Assessments of Risk (Ref: Para 7(b))

A19. 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, ***and the auditor plans to test those controls***. If substantially different controls were used at different times during the period under audit, each is considered separately.

[No amendment to paragraphs .A22--A24.]

.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.^{fn 9}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 requires the auditor to perform tests of ~~relevant~~ controls ***that address the risk for which substantive procedures alone cannot provide sufficient appropriate audit evidence***.

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^{fn 9} [Footnote omitted for purposes of this proposed SAS.]

[No amendment to paragraphs .A26--A28.]

.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 controls activities, such as *automated* controls ~~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.

[No amendment to paragraphs .A30--A31.]

.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~~ *IT application* (including the tables, files, or other permanent data used by the ~~program~~ *IT application*) 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~~ *may include testing the general IT controls related to the IT application 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. *Similarly, the auditor may perform tests of controls that address risks of material misstatement related to the integrity of the entity's data, or the completeness and accuracy of the entity's system-generated reports, or may determine they are necessary to address risks of material misstatement because substantive procedures alone cannot provide sufficient appropriate audit evidence. These tests of controls may include tests of general IT controls that address the matters in paragraph 10(a). When*

this is the case, the auditor may not need to perform any further testing to obtain audit evidence about the matters in paragraph 10a.

A34. *When the auditor determines that a general IT control is deficient, the auditor may consider the nature of the related risk(s) arising from the use of IT that were identified in accordance with the proposed SAS^{fn 12} to provide the basis for the design of the auditor's additional procedures to address the assessed risk of material misstatement. Such procedures may address determining whether:*

- *The related risk(s) arising from IT has occurred. For example, if users have unauthorized access to an IT application (but cannot access or modify the system logs that track access), the auditor may decide to inspect the system logs to obtain audit evidence that those users did not access the IT application during the period.*
- *There are any alternate or redundant general IT controls, or any other controls, that address the related risk(s) arising from the use of IT. If so, the auditor may identify such controls (if not already -identified) and therefore evaluate their design, determine that they have been implemented and perform tests of their operating effectiveness. For example, if a general IT control related to user access is deficient, the entity may have an alternate control whereby IT management reviews end user access reports on a timely basis. Circumstances when an application control may address a risk arising from the use of IT may include when the information that may be affected by the general IT control deficiency can be reconciled to external sources (for example, a bank statement) or internal sources not affected by the general IT control deficiency (for example, a separate IT application or data source).*

^{fn 12} AU-C section 315, paragraph 41

[Paragraphs .A33–.A77 renumbered as .A35 to .A79. Subsequent footnotes renumbered.]

.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, general IT controls). As explained in paragraphs A33 to A34, general IT controls may have been identified in accordance with the proposed SAS because of their support of the operating effectiveness of automated controls or due to their support in maintaining the integrity of information used in the entity's financial reporting, including system-generated reports. The requirement in paragraph 10b acknowledges that the auditor may have already tested certain indirect controls to address the matters in paragraph 10a. 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.

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~~.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 **controls in the entity's process to monitoring the system of internal** of controls.

[No amendment to paragraphs .A36--A37.]

.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, and its reliability**. 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 **and reliability** 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.

[No amendment to paragraph .A40.]

.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, 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

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- A ~~deficiency~~ **in the entity's process to monitoring of the system of internal 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

[No amendment to paragraphs .A42--.A44.]

Substantive Procedures (Ref: par. 6 and .18)

.A45 Paragraph .18 requires the auditor to design and perform substantive procedures for all relevant assertions related to each ~~material~~ **significant** class of transactions, account balance, and disclosure, ~~irrespective of the assessed risks of material misstatement.~~ **For such classes of transactions, account balances, and disclosures, substantive procedures may have already been performed because paragraph 6 requires the auditor to design and perform further audit procedures that are responsive to the assessed risks of material misstatement at the assertion level. Accordingly, substantive procedures are required to be designed and performed in accordance with paragraph 18** when the further audit procedures designed and performed in accordance with paragraph 6 for significant classes of transactions, account balances, or disclosures, designed and performed in accordance with paragraph 6, did not include substantive procedures.

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 controls exist, including management override.

[No amendment to paragraphs .A46--.A47.]

.A48 The ~~nature assessment~~ **of the risk and or the nature of the** 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~~ **controls which the auditor plans to test**, 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.

[No amendment to paragraphs .A50–.A60.]

.A61 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

[No amendment to paragraph .A62]

.A63 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:

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- 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

[No amendment to paragraphs .A64–.A72.]

.A73 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 *of material misstatement for all or some and the effect on the of significant* classes of transactions, account balances, or disclosures and ~~related~~ *their relevant* assertions. Section 315 contains further guidance on revising the auditor’s risk assessment. ^{fn 13}

^{fn 13} [Footnote omitted for purposes of this proposed SAS.]

[No amendment to paragraph .A74]

.A75 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.

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- 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, ***the applicable financial reporting framework and including its entity's system of internal control.***

Documentation (Ref: par. .30)

.A76 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; ***system of*** internal control of the entity; availability of information from the entity; and the audit methodology and technology used in the audit.

[No further amendment to AU-C section 330.]

AU-C section 402, *Audit Considerations Relating to an Entity Using a Service Organization*

.01 This section addresses the user auditor's responsibility for obtaining sufficient appropriate audit evidence in an audit of the financial statements of a user entity that uses one or more service organizations. Specifically, it expands on how the user auditor applies [section 315](#), *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, and [section 330](#), *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, in obtaining an understanding of the user entity, including ***the entity's system of*** internal control relevant to ***the preparation of the financial statements*** the audit, sufficient to identify and assess the risks of material misstatement and in designing and performing further audit procedures responsive to those risks.

[No amendment to paragraph .02.]

.03 Services provided by a service organization are relevant to the audit of a user entity's financial statements when those services and the controls over them affect the user entity's information system, ~~including related business processes, relevant to financial reporting~~ ***the preparation of the financial statements***. Although ~~most~~ ***Most*** controls at the service organization are likely to ~~relate to financial reporting~~ ***be part of the user entity's information system relevant to the preparation of the financial statements or other related controls also may be relevant to the audit***, such as controls over the safeguarding

of assets. A service organization's services are part of a user entity's information system, ~~including related business processes, relevant to financial reporting~~ if these services affect any of the following:

- a. ***How information relating to significant classes of transactions, account balances and disclosures flows through the user entity's information system, whether manually or using IT, and whether obtained from within or outside the general ledger and subsidiary ledgers. The classes of transactions in the user entity's operations that are significant to the user entity's financial statements; This includes when the service organization affects how:***
 - b.i. ~~The procedures within both IT and manual systems by which the user entity's transactions are initiated, authorized, recorded, processed, corrected as necessary, transferred to the general ledger, and reported in the financial statements; Transactions of the user entity are initiated, and how information about them is recorded, processed, corrected as necessary, and incorporated in the general ledger and reported in the financial statements; and~~
 - ii. ***Information about events or conditions, other than transactions, is captured, processed and disclosed by the user entity in the financial statements.***
- e. b. ~~The related accounting records, supporting information, and specific accounts in the user entity's financial statements and other supporting records relation to the flows of information paragraph 3a that are used to initiate, authorize, record, process, and report the user entity's transactions. This includes the correction of incorrect information and how information is transferred to the general ledger; the records may be in either manual or electronic form;~~
- d. ~~How the user entity's information system captures events and conditions, other than transactions, that are significant to the financial statements;~~
- e e. ~~The financial reporting process used to prepare the user entity's financial statements from the records described in paragraph 3b including as it relates to disclosures and to accounting estimates relating to significant classes of transactions, account balances and disclosures accounting estimates and disclosures; and~~
- d. ***The entity's IT environment relevant to (a) to (c) above***
- f. ~~Controls surrounding journal entries, including nonstandard journal entries used to record nonrecurring, unusual transactions, or adjustments.~~

[No amendment to paragraph .04-.06.]

.07 The objectives of the user auditor, when the user entity uses the services of a service organization, are to

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- a. obtain an understanding of the nature and significance of the services provided by the service organization and their effect on the user entity's **system of** internal control ~~relevant to the audit~~, sufficient to **provide an appropriate basis for the identification and assessment of** ~~identify and assess~~ the risks of material misstatement.
- b. design and perform audit procedures responsive to those risks.

[No amendment to paragraph .08-.10.]

.10 When obtaining an understanding of **the entity's system of** internal control relevant to the audit in accordance with [section 315](#)^{fn 1}, the user auditor **should identify controls in the control activities component** ~~evaluate the design and implementation of relevant controls~~ at the user entity **from those** that relate to the services provided by the service organization, including those that are applied to the transactions processed by the service organization, **and evaluate their design and determine whether they have been implemented.**^{fn 2}

^{fn 1} **Paragraph 26a of AU-C section 315.**

^{fn 2} **Paragraph 26b of AU-C section 315.**

[Subsequent footnotes renumbered.]

.11 The user auditor should determine whether a sufficient understanding of the nature and significance of the services provided by the service organization and their effect on the user entity's **system of** internal control ~~relevant to the audit~~ has been obtained to provide an **appropriate** basis for the identification and assessment of **the** risks of material misstatement.

.12 If the user auditor is unable to obtain a sufficient understanding from the user entity, the user auditor should obtain that understanding from one or more of the following procedures:

- a. Obtaining and reading a type 1 or type 2 report, if available
- b. Contacting the service organization, through the user entity, to obtain specific information
- c. Visiting the service organization and performing procedures that will provide the necessary information about the ~~relevant~~ controls at the service organization
- d. Using another auditor to perform procedures that will provide the necessary information about the relevant controls at the service organization (Ref: [par. A15-A20](#))

[No amendment to paragraph .13.]

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.14 If the user auditor plans to use a type 1 or type 2 report as audit evidence to support the user auditor's understanding about the design and implementation of controls at the service organization, the user auditor should

- a. evaluate whether the type 1 report is as of a date, or in the case of a type 2 report, is for a period that is appropriate for the user auditor's purposes;
- b. evaluate the sufficiency and appropriateness of the evidence provided by the report for the understanding of ~~the user entity's internal controls at the service organization relevant to the audit~~ **controls at the service organization**; and
- c. determine whether complementary user entity controls identified by the service organization are relevant in addressing the risks of material misstatement relating to the relevant assertions in the user entity's financial statements and, if so, obtain an understanding of whether the user entity has designed and implemented such controls. (Ref: [par. .A23–.A24](#))

[No amendment to paragraph .15–.A18.]

.A19 Another auditor may be used to perform procedures that will provide the necessary information about the relevant controls at the service organization **related to services provided to the user entity**. If a type 1 or type 2 report has been issued, the user auditor may use the service auditor to perform these procedures as the service auditor has an existing relationship with the service organization. The user auditor using the work of another auditor may find the guidance in section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, useful as it relates to understanding another auditor (including that auditor's independence and professional competence); involvement in the work of another auditor in planning the nature, extent, and timing of such work; and in evaluating the sufficiency and appropriateness of the audit evidence obtained.^{fn 6}

^{fn 6} [Footnote omitted for purposes of this proposed SAS.]

[No amendment to paragraphs .A20–.A21.]

.A24 A type 1 or type 2 report, along with information about the user entity, may assist the user auditor in obtaining an understanding of the following:

- a. The controls at the service organization that may affect the processing of the user entity's transactions, including the use of subservice organizations
- b. The flow of significant transactions through the service organization's system to determine the points in the transaction flow where material misstatements in the user entity's financial statements could occur
- c. The control objectives stated in the description of the service organization's system that are relevant to the user entity's financial statement assertions

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- d.* Whether controls at the service organization are suitably designed and implemented to prevent, or detect and correct, processing errors that could result in material misstatements in the user entity's financial statements

A type 1 or type 2 report may assist the user auditor in obtaining a sufficient understanding to identify and assess the risks of material misstatement of the user entity's financial statements. A type 1 report, however, does not provide any evidence of the operating effectiveness of the ~~relevant~~ controls.

[No amendment to paragraphs .A25--A30.]

.A31 The user auditor is required by [section 330](#) to design and perform tests of controls to obtain sufficient appropriate audit evidence concerning the operating effectiveness of ~~relevant~~ controls in certain circumstances.^{fn 8} In the context of a service organization, this requirement applies when

- a.* the user auditor's assessment of risks of material misstatement includes an expectation that the controls at the service organization are operating effectively (that is, the user auditor intends to rely on the operating effectiveness of controls at the service organization in determining the nature, timing and extent of substantive procedures); or
- b.* substantive procedures alone, or in combination with tests of the operating effectiveness of controls at the user entity, cannot provide sufficient appropriate audit evidence at the assertion level.

^{fn 8} [Footnote omitted for purposes of this proposed SAS.]

.A32 If a type 2 report is not available, a user auditor may contact the service organization through the user entity to request that a service auditor be engaged to perform a type 2 engagement that includes tests of the operating effectiveness of the relevant controls or the user auditor may use another auditor to perform agreed-upon procedures at the service organization that test the operating effectiveness of those controls. A user auditor may also visit the service organization and perform tests of ~~relevant~~ controls if the service organization agrees to it. The user auditor's risk assessments are based on the combined evidence provided by the service auditor's report and the user auditor's own procedures.

[No amendment to paragraphs .A33--A34.]

.A35 It may also be necessary for the user auditor to obtain additional evidence about significant changes in the ~~relevant~~ controls at the service organization during a period outside the period covered by the type 2 report, or to determine what additional audit procedures need to be performed (for example, when little or no overlap exists between the period covered by the type 2 report and the period covered by the user entity's financial statements). Relevant factors in determining what additional audit evidence to

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obtain about controls at the service organization that were operating outside the period covered by the service auditor's report may include the following:

- The significance of the assessed risks of material misstatement at the assertion level
- The specific controls that were tested during the interim period and significant changes to them since they were tested including changes in the information systems, 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 user auditor intends to reduce further substantive procedures based on the reliance on controls
- The effectiveness of the control environment and ***the user entity's process to monitoring the system of internal controls*** ~~at the user entity~~

.A36 Additional audit evidence may be obtained, for example, by performing tests of controls that operated during the remaining period or testing the user entity's ***process to monitoring the system of internal controls***.

[No amendment to paragraphs .A37--A40.]

.A41 *Communication of significant deficiencies and material weaknesses in internal control identified during the audit.* The user auditor is required by section 265, *Communicating Internal Control Related Matters Identified in an Audit*, to communicate in writing to management and those charged with governance significant deficiencies and material weaknesses identified during the audit.^{fn 9} Matters related to the use of a service organization that the user auditor may identify during the audit and may communicate to management and those charged with governance of the user entity include the following:

- Any ***controls within the entity's process to monitor the system of internal control*** ~~needed monitoring controls~~ that could be implemented by the user entity, including those identified as a result of obtaining a type 1 or type 2 report
- Instances when complementary user entity controls identified in the type 1 or type 2 report are not implemented at the user entity
- Controls that may be needed at the service organization that do not appear to have been implemented or that were implemented, but are not operating effectively

^{fn 9} [Footnote omitted for purposes of this proposed SAS.]

[No further amendment to AU-C section 402.]

AU-C section 501, *Audit Evidence—Specific Considerations for Selected Items*

[No amendment to paragraphs .01–.A22.]

.A23 Matters relevant in evaluating management’s instructions and procedures for recording and controlling the physical inventory counting include whether they address, for example, the following:

- The application of appropriate controls activities (for example, the collection of used physical inventory count records, accounting for unused physical inventory count records, and count and recount procedures)
- The accurate identification of the stage of completion of work in progress; slow moving, obsolete, or damaged items; and inventory owned by a third party (for example, on consignment)
- The procedures used to estimate physical quantities, when applicable, such as may be needed in estimating the physical quantity of a coal pile
- Control over the movement of inventory between areas and the shipping and receipt of inventory before and after the cutoff date

[No further amendment to AU-C section 501.]

AU-C section 530, *Audit Sampling*

[No amendment to paragraphs .01–.A9.]

.A10 In considering the test objective and characteristics of a population for tests of controls, the auditor makes an assessment of the expected rate of deviation based on the auditor’s understanding of the relevant controls. This assessment is made in order to design an audit sample and determine sample size. For example, if the expected rate of deviation is unacceptably high, the auditor will normally decide not to perform tests of controls. Similarly, for tests of details, the auditor makes an assessment of the expected misstatement in the population. If the expected misstatement is high, 100 percent examination or increasing the sample size may be appropriate when performing tests of details.

[No further amendment to AU-C section 530.]

AU-C section 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures

[No amendment to paragraphs .01–.03.]

Key Concepts of This SAS

4. AU-C section 315 requires ***inherent risk and control risk to be assessed separately for identified risks of material misstatement*** ~~the auditor to assess the risk of material misstatement at the relevant assertion level. For this purpose, this SAS requires inherent risk and control risk to be assessed separately for accounting estimates.~~ ***In the context of this section and depending*** ~~Depending~~ on the nature of a particular accounting estimate, the susceptibility of an assertion to a misstatement that could be material may be subject to or affected by estimation uncertainty, complexity, subjectivity, or other inherent risk factors, and the interrelationship among them. As explained in AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*² inherent risk is ***influenced by inherent risk factors***. ~~higher for some assertions and related classes of transactions, account balances, and disclosures than for others.~~ Accordingly, the assessment of inherent risk depends on the degree to which the inherent risk factors affect the ***susceptibility to misstatement of an assertion, and the level of inherent risk likelihood or magnitude of misstatement*** ~~and varies on a scale that is referred to in this SAS as the *spectrum of inherent risk*.~~ In assessing control risk, the auditor takes into account whether the auditor's further audit procedures contemplate planned reliance on the operating effectiveness of controls. If the auditor does not ***intend to test and rely on the operating effectiveness of controls***, ~~perform tests of controls,~~ the auditor's assessment of ***control risk is such that the assessment of the risk of material misstatement is the same as the assessment of inherent risk***. ~~the risk of material misstatement at the relevant assertion level cannot be reduced for the effective operation of controls with respect to the particular assertion.~~ (Ref: par. .A8–.A10, .A65–.A66, and app. A)

² [Footnote omitted for purposes of this proposed SAS.]

5. This SAS refers to relevant requirements in AU-C sections 315 and 330 and provides related guidance to emphasize the importance of the auditor's decisions about controls relating to accounting estimates, including decisions about whether
- there are controls ***identified in accordance with paragraph 27 of AU-C section 315*** ~~relevant to the audit~~, for which the auditor is required to evaluate their design and determine whether they have been implemented.
 - to test the operating effectiveness of ~~relevant~~ controls.

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6. This ~~section-SAS~~ emphasizes that the auditor's further audit procedures (including, when appropriate, tests of controls) need to be responsive to the reasons for the assessed risks of material misstatement at the relevant assertion level, taking into account the effect of one or more inherent risk factors and the auditor's assessment of control risk.
7. The exercise of professional skepticism in relation to accounting estimates is affected by the auditor's consideration of inherent risk factors, and its importance increases when accounting estimates are subject to a greater degree of estimation uncertainty or are affected to a greater degree by complexity, subjectivity, or other inherent risk factors. Similarly, the exercise of professional skepticism is important when there is greater susceptibility to misstatement due to management bias or *other fraud risk factors insofar as they affect inherent risk*. (Ref: par. .A11)
8. This SAS requires the auditor to evaluate, based on the audit procedures performed and the audit evidence obtained, whether the accounting estimates and related disclosures are reasonable ³in the context of the applicable financial reporting framework or are misstated. For purposes of this SAS, *reasonable*, in the context of the applicable financial reporting framework, means that the relevant requirements of the applicable financial reporting framework have been applied appropriately, including those that address the following: (Ref: par. .A12-.A13 and .A139-.A144)
 - The development of the accounting estimate, including the selection of the method, assumptions, and data in view of the nature of the accounting estimate and the facts and circumstances of the entity
 - The selection of management's point estimate
 - The disclosures about the accounting estimate, including disclosures about how the accounting estimate was developed and that explain the nature, extent, and sources of estimation uncertainty

³ [Footnote omitted for purposes of this proposed SAS.]

[No proposed amendment to paragraphs .09-.11.]

Requirements

Risk Assessment Procedures and Related Activities

12. When obtaining an understanding of the entity and its environment, *the applicable financial reporting framework and including* the entity's *system of* internal control, as required by AU-C section 315, the auditor should obtain an understanding of the following matters related to the entity's accounting estimates. The auditor's procedures to obtain the understanding should be performed to the extent necessary to *obtain audit evidence that* provides an appropriate basis for the identification and assessment of risks of material misstatement at the financial statement and relevant assertion levels ⁴ (Ref: par. .A19-.A23)

⁴ [Footnote omitted for purposes of this proposed SAS.]

Obtaining an Understanding of the ~~The Entity and Its Environment~~ and the Applicable Financial Reporting Framework

- a. The entity's transactions and other events ~~or and~~ conditions that may give rise to the need for or changes in accounting estimates to be recognized or disclosed in the financial statements (Ref: par. .A24)
- b. The requirements of the applicable financial reporting framework related to accounting estimates (including the recognition criteria, measurement bases, and the related presentation and disclosure requirements) and how they apply in the context of the nature and circumstances of the entity and its environment, including how ~~transactions and other events or conditions are subject to or affected by~~ ***the*** inherent risk factors ***affect susceptibility to misstatement of assertions***. (Ref: par. .A25–.A26)
- c. Regulatory factors relevant to the entity's accounting estimates, including, when applicable, regulatory frameworks (Ref: par. .A27)
- d. The nature of the accounting estimates and related disclosures that the auditor expects to be included in the entity's financial statements, based on the auditor's understanding of the matters in paragraph 12a–c of this SAS (Ref: par. .A28)

Obtaining an Understanding of the ~~The Entity's~~ System of Internal Control

- e. The nature and extent of oversight and governance that the entity has in place over management's financial reporting process relevant to accounting estimates (Ref: par. .A29–.A31)
- f. How management identifies the need for and applies specialized skills or knowledge related to accounting estimates, including with respect to the use of a management's specialist (Ref: par. .A32)
- g. How the entity's risk assessment process identifies and addresses risks relating to accounting estimates (Ref: par. .A33–.A34)
- h. The entity's information system as it relates to accounting estimates, including the following:
 - i. ***How information relating to accounting estimates and related disclosures for significant classes of transactions, account balances or disclosures flows through the entity's information system***~~The classes of transactions, events, and conditions that are significant to the financial statements and that give rise to the need for or changes in accounting estimates and related disclosures~~ (Ref: par. .A20 and .A35)

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- ii. For such accounting estimates and related disclosures, how management
 - (1) identifies the relevant methods, assumptions, or sources of data, and the need for changes in them, that are appropriate in the context of the applicable financial reporting framework, including how management (Ref: par. .A36–.A37)
 - (a) selects or designs, and applies, the methods used, including the use of models (Ref: par. .A38–.A39)
 - (b) selects the assumptions to be used, including consideration of alternatives, and identifies significant assumptions (Ref: par. .A40–.A43)
 - (c) selects the data to be used (Ref: par. .A44)
 - (2) understands the degree of estimation uncertainty, including by considering the range of possible measurement outcomes (Ref: par. .A45)
 - (3) addresses the estimation uncertainty, including selecting a point estimate and related disclosures for inclusion in the financial statements (Ref: par. .A46–.A49)
 - i. **Identified controls in the control activities component**⁵ ~~Control activities relevant to the audit~~ over management’s process for making accounting estimates as described in paragraph 12h(ii) of this SAS (Ref: par. .A50–.A54)
 - j. How management reviews the outcomes of previous accounting estimates and responds to the results of that review
13. The auditor should review the outcome of previous accounting estimates or, when applicable, their subsequent re-estimation to assist in identifying and assessing the risks of material misstatement in the current period. The auditor should take into account the characteristics of the accounting estimates in determining the nature and extent of that review. The review is not intended to call into question judgments about previous-period accounting estimates that were appropriate based on the information available at the time they were made. (Ref: par. .A55–.A60)
14. With respect to accounting estimates, the auditor should determine whether the engagement team requires specialized skills or knowledge to perform the risk assessment procedures, to identify and assess the risks of material misstatement, to design and perform audit procedures to respond to those risks, or to evaluate the audit evidence obtained. (Ref: par. .A61–.A63)

⁵ Paragraph 26a(i)-(iv) in proposed SAS, Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment.

[Subsequent footnotes renumbered.]

Identifying and Assessing the Risks of Material Misstatement

15. In identifying and assessing the risks of material misstatement relating to an accounting estimate and related disclosures at the relevant assertion level, **including separately assessing inherent risk and control risk at the relevant assertion level**, as required by AU-C section 315,⁵ the auditor should ~~separately assess inherent risk and control risk. The auditor should~~ take the following into account in identifying the risks of material misstatement and assessing inherent risk: (Ref: par. .A64-.A71)
- a. The degree to which the accounting estimate is subject to estimation uncertainty (Ref: par. .A72-.A75)
 - b. The degree to which one or both of the following are affected by complexity, subjectivity, or other inherent risk factors: (Ref: par. .A76-.A79)
 - i. The selection and application of the method, assumptions, and data in making the accounting estimate
 - ii. The selection of management's point estimate and related disclosures for inclusion in the financial statements
16. The auditor should determine whether any of the risks of material misstatement identified and assessed in accordance with paragraph 15 are, in the auditor's judgment, a significant risk.⁶ If the auditor has determined that a significant risk exists, the auditor should **identify controls that address** ~~obtain an understanding of the entity's controls, including control activities, relevant to that risk,¹ and, based on that understanding,~~ evaluate whether such controls have been suitably designed and implemented to mitigate such risks.⁷ (Ref: par. .A80)

Responses to the Assessed Risks of Material Misstatement

17. As required by AU-C section 330⁸ the auditor's further audit procedures should be responsive to the assessed risks of material misstatement at the relevant assertion level⁹ considering the reasons for the assessment given to those risks. The auditor's further audit procedures should include one or more of the following approaches:
- a. Obtaining audit evidence from events occurring up to the date of the auditor's report (see paragraph 20 of this SAS)

⁵ Paragraphs .31-.3426-27 of *proposed SAS, Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment* AU-C section 315.

⁶ Paragraph .3228 of AU-C section 315.

¹ *Paragraph .26(a)(i) of AU-C section 315* [Subsequent footnotes renumbered]

⁷ Paragraph .26(a)-30 of AU-C section 315.

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- b. Testing how management made the accounting estimate (see paragraphs 21–26 of this SAS)
- c. Developing an auditor’s point estimate or range (see paragraphs 27–28 of this SAS)

The auditor’s further audit procedures should take into account that the higher the assessed risk of material misstatement, the more persuasive the audit evidence needs to be. ¹⁰The auditor should design and perform further audit procedures in a manner that is not biased toward obtaining audit evidence that may be corroborative or toward excluding audit evidence that may be contradictory. (Ref: par. .A81–A84)

^{8, 9, and 10} [Footnotes omitted for purposes of this proposed SAS.]

18. As required by AU-C section 330,¹¹ the auditor should design and perform tests 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, or
- b. substantive procedures alone cannot provide sufficient appropriate audit evidence at the relevant assertion level.

In relation to accounting estimates, the auditor’s tests of such controls should be responsive to the reasons for the assessment given to the risks of material misstatement. 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.¹² (Ref: par. .A85–.A89)

19. For a significant risk relating to an accounting estimate, the auditor’s further audit procedures should include tests of controls in the current period if the auditor plans to rely on those controls. When the approach to a significant risk consists only of substantive procedures, those procedures should include tests of details.¹³ (Ref: par. A90)

¹³ [Footnote omitted for purposes of this proposed SAS.]

[No amendment to paragraphs .20–.A7.]

Application and Other Explanatory Material

...

Key Concepts of This SAS

¹¹ Paragraph .08 of AU-C section 330.

¹² Paragraph .09 of AU-C section 330.

Inherent Risk Factors (Ref: par. 04)

A8. ~~Inherent risk factors are characteristics of conditions and events~~ ***or conditions*** that may affect the susceptibility of an assertion to misstatement, ***whether due to fraud or error, of an assertion about a class of transactions, account balance or disclosure,*** before consideration of controls.² Appendix A, “Inherent Risk Factors,” further explains the nature of these inherent risk factors, and their interrelationships, in the context of making accounting estimates and their presentation in the financial statements.

A9. ~~In addition to the inherent risk factors of estimation uncertainty, complexity, or subjectivity, other inherent risk factors that the auditor may consider in identifying and~~ ***When assessing the risks of material misstatement at the assertion level,³ in addition to estimation uncertainty, complexity, and subjectivity, the auditor also takes into account the degree*** ~~may include the extent to which~~ ***other inherent risk factors included in AU-C section 315 affect susceptibility of assertions to misstatement about the accounting estimate. Such additional inherent risk factors include the following:*** ~~is subject to or affected by~~

- a change in the nature or circumstances of the relevant financial statement items, or requirements of the applicable financial reporting framework, which may give rise to the need for changes in the method, assumptions, or data used to make the accounting estimate.
- susceptibility to misstatement due to management bias or ***other fraud risk factors insofar as they affect inherent risk,*** in making the accounting estimate.
- ***Uncertainty, other than estimation uncertainty.***

Control Risk

A10. ~~An important consideration for the auditor in~~ ***In*** assessing control risk at the relevant assertion level ***in accordance with AU-C section 315, the auditor takes into account is the effectiveness of the design of the controls that whether the auditor intends plans to rely on test the operating effectiveness of controls, and the extent to which the controls address the assessed inherent risks at the relevant assertion level. When the auditor is considering whether to test the operating effectiveness of controls, the*** ~~The auditor’s evaluation that controls are effectively designed and have been implemented supports an expectation, by the auditor, about the operating effectiveness of the controls in determining whether~~ ***establishing the plan*** to test them.

[No amendment to paragraphs .A11–.A18. Paragraph A20, A22, A23, A26-A27, and A30-A33 have been included for contextual purposes.]

²² Paragraph .12 of AU-C section 315. [Subsequent footnotes renumbered.]

³³ Paragraph 31 of AU-C section 315. [Subsequent footnotes renumbered.]

Risk Assessment Procedures and Related Activities

Obtaining an Understanding of the Entity and Its Environment, the Applicable Financial Reporting Framework, and the Entity's System of Internal Control (Ref: par. 12)

A19 AU-C section 315²⁴ requires the auditor to obtain an understanding of certain matters about the entity and its environment, ***the applicable financial reporting framework and including*** the entity's ***system of*** internal control. The requirements in paragraph 12 of this SAS relate more specifically to accounting estimates and build on the broader requirements in AU-C section 315.

²⁴ [Footnote omitted for purposes of this proposed SAS.]

A20. The classes of transactions, events, and conditions within the scope of paragraph 12*h* of this SAS are the same as the classes of transactions, events, and conditions relating to accounting estimates and related disclosures that are subject to AU-C section 315²⁵ In obtaining the understanding of the entity's information system as it relates to accounting estimates, the auditor may consider

- whether the accounting estimates arise from the recording of routine and recurring transactions or whether they arise from nonrecurring or unusual transactions.
- how the information system addresses the completeness of accounting estimates and related disclosures, in particular, for accounting estimates related to liabilities.

²⁵ [Footnote omitted for purposes of this proposed SAS.]

Scalability

A21. The nature, timing, and extent of the auditor's procedures to obtain the understanding of the entity and its environment, ~~including the applicable financial reporting framework, and~~ the entity's ***system of*** internal control, related to the entity's accounting estimates, may depend, to a greater or lesser degree, on the extent to which the individual matters apply in the circumstances. For example, the entity may have few transactions or other events ~~and~~ conditions that give rise to the need for accounting estimates; the applicable financial reporting requirements may be simple to apply; and there may be no relevant regulatory factors. Further, the accounting estimates may not require significant judgments, and the process for making the accounting estimates may be less complex. In these circumstances, the accounting estimates may be subject to or affected by estimation uncertainty, complexity, subjectivity, or other inherent risk factors to a lesser degree, and there may be fewer ***identified*** controls ~~in the control activities component. relevant to the audit.~~ If so, the auditor's risk assessment procedures are likely to be less extensive and may be performed primarily through inquiries of management with appropriate responsibilities for the financial statements, ~~such as and~~ observation of management's process for making the accounting estimate ***(including when evaluating whether identified controls in that process are designed***

effectively and when determining whether the control has been implemented).

A22. By contrast, the accounting estimates may require significant judgments by management, and the process for making the accounting estimates may be complex and involve the use of complex models. In addition, the entity may have a more sophisticated information system and more extensive controls over accounting estimates. In these circumstances, the accounting estimates may be subject to or affected by estimation uncertainty, subjectivity, complexity, or other inherent risk factors to a greater degree. If so, the nature or timing of the auditor's risk assessment procedures are likely to be different, or more extensive, than in the circumstances in paragraph A21.

A23. The following considerations may be relevant for entities with only simple businesses, which may include many smaller entities: (Ref: par. A72 and A149)

- Processes relevant to accounting estimates may be uncomplicated because the business activities are simple or the required estimates may have a lesser degree of estimation uncertainty.
- Accounting estimates may be generated outside of the general and subsidiary ledgers, controls over their development may be limited, and an owner-manager may have significant influence over their determination. The owner-manager's role in making the accounting estimates may need to be taken into account by the auditor both when identifying the risks of material misstatement and when considering the risk of management bias.

The Entity and Its Environment

The Entity's Transactions and Other Events ~~or~~ Conditions (Ref: par. 12a)

A24. Changes in circumstances that may give rise to the need for or changes in accounting estimates may include, for example, whether

- the entity has engaged in new types of transactions,
- terms of transactions have changed, or
- new events or conditions have occurred.

The Requirements of the Applicable Financial Reporting Framework (Ref: par. 12b)

A25. Obtaining an understanding of the requirements of the applicable financial reporting framework provides the auditor with a basis for discussion with management and, where applicable, those charged with governance about how management has applied ~~the~~ ~~those~~ requirements *of the applicable financial reporting framework* relevant to the accounting estimates, and about the auditor's determination of whether they have been applied appropriately. This understanding also may assist the auditor in communicating

with those charged with governance when the auditor considers a significant accounting practice that is acceptable under the applicable financial reporting framework to not be the most appropriate in the circumstances of the entity.²⁶

A26. In obtaining this understanding, the auditor may seek to understand whether

- the applicable financial reporting framework
 - prescribes certain criteria for the recognition, or methods for the measurement of, accounting estimates,
 - specifies certain criteria that permit or require measurement at a fair value, for example, by referring to management’s intentions to carry out certain courses of action with respect to an asset or liability, or
 - specifies required or suggested disclosures, including disclosures concerning judgments, assumptions, or other sources of estimation uncertainty relating to accounting estimates, and
- changes in the applicable financial reporting framework require changes to the entity’s accounting policies relating to accounting estimates.

Regulatory Factors (Ref: par. 12c)

A27. Obtaining an understanding of regulatory factors, if any, that are relevant to accounting estimates may assist the auditor in identifying applicable regulatory frameworks and in determining whether such regulatory frameworks

- address conditions for the recognition, or methods for the measurement, of accounting estimates or provides related guidance thereon,
- specify or provide guidance about disclosures in addition to the requirements of the applicable financial reporting framework,
- provide an indication of areas for which there may be a potential for management bias to meet regulatory requirements, or
- contain requirements for regulatory purposes that are not consistent with requirements of the applicable financial reporting framework, which may indicate potential risks of material misstatement. For example, some regulators may seek to influence minimum levels for expected credit loss provisions that exceed those required by the applicable financial reporting framework.

The Nature of the Accounting Estimates and Related Disclosures That the Auditor Expects to Be Included in the Financial Statements (Ref: par. 12d)

²⁶ Paragraph .12a of AU-C section 260.

A28. Obtaining an understanding of the nature of accounting estimates and related disclosures that the auditor expects to be included in the entity's financial statements assists the auditor in understanding the measurement basis of such accounting estimates and the nature and extent of disclosures that may be relevant. Such an understanding provides the auditor with a basis for discussion with management about how management makes the accounting estimates.

The Entity's System of Internal Control ~~Relevant to the Audit~~

The Nature and Extent of Oversight and Governance (Ref: par. 12e)

A29. In applying AU-C section 315²⁷ the auditor's understanding of the nature and extent of oversight and governance that the entity has in place over management's process for making accounting estimates may be important to the auditor's required evaluation ~~about as it relates to whether~~

- management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior, and
- ~~the strengths in the control environment elements collectively provide~~ **provides** an appropriate foundation for the other components of **the system of** internal control **considering the nature and size of the entity;** and
- ~~whether those other components are undermined by control deficiencies identified~~ in the control environment **undermine the other components of the system of internal control.**

²⁷ Paragraph .21a45 of AU-C section 315.

A30. The auditor may obtain an understanding of whether those charged with governance

- have the skills or knowledge to understand the characteristics of a particular method or model to make accounting estimates, or the risks related to the accounting estimate, for example, risks related to the method or IT used in making the accounting estimates, or the susceptibility of the accounting estimate to misstatement due to management bias or fraud,
- have the skills and knowledge to understand whether management made the accounting estimates in accordance with the applicable financial reporting framework,
- have the information required to evaluate on a timely basis how management made the accounting estimates, and the authority to call into question management's actions when those actions appear to be inadequate or inappropriate,

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- oversee management’s process for making the accounting estimates, including the use of models, or
- oversee the monitoring activities undertaken by management. This may include supervision and review procedures designed to detect and correct any deficiencies in the design or operating effectiveness of controls over the accounting estimates.

A31. Obtaining an understanding of the oversight by those charged with governance may be important when there are accounting estimates that

- require significant judgment by management to address subjectivity,
- have high estimation uncertainty,
- are complex to make, for example, because of the extensive use of IT, large volumes of data, or the use of multiple data sources or assumptions with complex interrelationships,
- had or ought to have had a change in the method, assumptions, or data compared to previous periods, or
- involve significant assumptions.

Management’s Application of Specialized Skills or Knowledge, Including the Use of Management’s Specialists (Ref: par. 12f)

A32. The auditor may consider whether the following circumstances increase the likelihood that management needs to engage a specialist²⁸

- The specialized nature of the matter requiring estimation, for example, the accounting estimate may involve measurement of mineral or hydrocarbon reserves in extractive industries or the evaluation of the likely outcome of applying complex contractual terms
- The complex nature of the models required to apply the relevant requirements of the applicable financial reporting framework, as may be the case in certain measurements, such as level 3 fair values²⁹
- The unusual or infrequent nature of the condition, transaction, or event requiring an accounting estimate

^{28 and 29} [Footnotes omitted for purposes of this proposed SAS.]

The Entity’s Risk Assessment Process (Ref: par. 12g)

A33. Understanding how the entity’s risk assessment process identifies and addresses risks relating to accounting estimates may assist the auditor in considering changes in the

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following:

- The requirements of the applicable financial reporting framework related to the accounting estimates
- The availability or nature of data sources that are relevant to making the accounting estimates or that may affect the reliability of the data used
- The entity's information system or IT environment
- Key personnel

A34. Matters that the auditor may consider in obtaining an understanding of how management identifies and addresses the susceptibility to misstatement due to management bias or fraud in making accounting estimates, include whether, and if so, how, management does the following:

- Pays particular attention to selecting or applying the methods, assumptions, and data used in making accounting estimates
- Monitors key performance indicators that may indicate unexpected or inconsistent performance compared with historical or budgeted performance or with other known factors
- Identifies financial or other incentives that may be a motivation for bias
- Monitors the need for changes in the methods, significant assumptions, or the data used in making accounting estimates
- Establishes appropriate oversight and review of models used in making accounting estimates
 - Requires documentation of the rationale for or an independent review of significant judgments made in making accounting estimates

The Entity's Information System Relating to Accounting Estimates (Ref: par. 12*h*(i))

A35. During the audit, the auditor may identify classes of transactions, events, ~~or~~ conditions that give rise to the need for accounting estimates and related disclosures that management failed to identify. AU-C section 315 addresses circumstances in which the auditor identifies risks of material misstatement that management failed to identify, including *considering the implications for the auditor's evaluation of determining whether there is a significant deficiency or material weakness in internal control with regard to the entity's risk assessment process.*³⁰

³⁰ [Footnote omitted for purposes of this proposed SAS.]

Management's Identification of the Relevant Methods, Assumptions, and Sources of Data
(Ref: par. 12h(ii)(1))

A36. If management has changed the method for making an accounting estimate, considerations may include whether the new method is, for example, more appropriate; is itself a response to changes in the environment or circumstances affecting the entity or to changes in the requirements of the applicable financial reporting framework or regulatory environment; or whether management has another valid reason.

A37. If management has not changed the method for making an accounting estimate, considerations may include whether the continued use of the previous methods, assumptions, and data is appropriate in view of the current environment or circumstances.

Methods (Ref: par. 12h(ii)(1)(a))

A38. The applicable financial reporting framework may prescribe the method to be used in making an accounting estimate. In many cases, however, the applicable financial reporting framework does not prescribe a single method, or the required measurement basis prescribes, or allows, the use of alternative methods.

Models

A39. Management may design and implement specific controls around models used for making accounting estimates, whether it's management's own model or an external model. When the model itself has an increased level of complexity or subjectivity, such as an expected credit loss model or a fair value model using level 3 inputs, controls that address such complexity or subjectivity may be more likely to be identified as relevant to the audit. When complexity in relation to models is present, controls over data integrity are also more likely to be **identified controls in accordance with paragraph 27 of AU-C section 315** relevant to the audit. Factors that may be appropriate for the auditor to consider in obtaining an understanding of the model and **related identified controls** control activities relevant to the audit include the following:

- How management determines the relevance and accuracy of the model.
 - The validation or back-testing of the model, including whether the model is validated prior to use and revalidated at regular intervals to determine whether it remains suitable for its intended use. The entity's validation of the model may include evaluation of
 - the model's theoretical soundness,
 - the model's mathematical integrity, and
 - the accuracy and completeness of the data and the appropriateness of data and assumptions used in the model.

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- How the model is appropriately changed or adjusted on a timely basis for changes in market or other conditions and whether there are appropriate change control policies over the model.
- Whether adjustments, also referred to as *overlays* in certain industries, are made to the output of the model and whether such adjustments are appropriate in the circumstances in accordance with the requirements of the applicable financial reporting framework. When the adjustments are not appropriate, such adjustments may be indicators of possible management bias.
- Whether the model is adequately documented, including its intended applications, limitations, key parameters, required data and assumptions, and the results of any validation performed on it and the nature of and basis for any adjustments made to its output.

Examples of valuation models may include the present value of expected future cash flows, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis.

[No amendment to paragraphs .A40-.A43.]

Data (Ref: par. 12h(ii)(1)(c))

A44. Matters that the auditor may consider in obtaining an understanding of how management selects the data on which the accounting estimates are based include the following:

- The nature and source of the data, including information obtained from an external information source
- How management evaluates whether the data is appropriate
- The accuracy and completeness of the data
- The consistency of the data used with data used in previous periods
- The complexity of the IT ***applications or other aspects of the entity's IT environment*** systems used to obtain and process the data, including when this involves handling large volumes of data
- How the data is obtained, transmitted, and processed and how its integrity is maintained

[No amendments to paragraphs .A45-.A49.]

Identified Controls ~~Control Activities Relevant to the Audit~~ Over Management's Process for Making Accounting Estimates (Ref: par. 12i)

A50. The auditor's judgment in identifying controls ~~relevant to the audit~~ **in the control activities component**, and, therefore, the need to evaluate the design of those controls and determine whether they have been implemented, relates to management's process described in paragraph 12h(ii). The auditor may not identify ~~controls relevant control activities~~ in relation to all ~~the elements~~ **aspects** of paragraph 12h(ii). ~~depending on the complexity associated with the accounting estimate.~~

A51. As part of ~~obtaining an understanding of~~ **identifying** the ~~controls control activities relevant to the audit~~, the auditor may consider the following:

- How management determines the appropriateness of the data used to develop the accounting estimates, including when management uses an external information source or data from outside the general and subsidiary ledgers.
- The review and approval of accounting estimates, including the assumptions or data used in their development, by appropriate levels of management and, where appropriate, those charged with governance.
- The segregation of duties between those responsible for making the accounting estimates and those committing the entity to the related transactions, including whether the assignment of responsibilities appropriately takes account of the nature of the entity and its products or services. For example, in the case of a large financial institution, relevant segregation of duties may consist of an independent function responsible for estimation and validation of fair value pricing of the entity's financial products staffed by individuals whose remuneration is not tied to such products.
- The effectiveness of the design of the ~~controls control activities~~. Generally, it may be more difficult for management to design controls that address subjectivity and estimation uncertainty in a manner that effectively prevents, or detects and corrects, material misstatements than it is to design controls that address complexity. Controls that address subjectivity and estimation uncertainty may need to include more manual elements, which may be less reliable than automated controls as they can be more easily bypassed, ignored, or overridden by management. The design effectiveness of controls addressing complexity may vary depending on the reason for and the nature of the complexity. For example, it may be easier to design more effective controls related to a method that is routinely used or over the integrity of data.

A52. When management makes extensive use of IT in making an accounting estimate, **identified** controls ~~relevant to the audit~~ **in the control activities component** are likely to include general IT controls and ~~application~~ **information processing** controls. Such controls may address risks related to the following:

- Whether the **IT application or other aspects of the IT environment** ~~system~~ have the capability and is appropriately configured to process large volumes of data.

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- Complex calculations in applying a method. When diverse ***IT applications systems*** are required to process complex transactions, regular reconciliations between the ***IT applications systems*** are made, in particular, when the ***IT applications systems*** do not have automated interfaces or may be subject to manual intervention.
- Whether the design and calibration of models is periodically evaluated.
- The complete and accurate extraction of data regarding accounting estimates from the entity's records or from external information sources.
- Data, including the complete and accurate flow of data through the entity's information system, the appropriateness of any modification to the data used in making accounting estimates, and the maintenance of the integrity and security of the data. When using external information sources, risks related to processing or recording the data.
- Whether management has controls around access, change, and maintenance of individual models to maintain a strong audit trail of the accredited versions of models and to prevent unauthorized access or amendments to those models.
- Whether there are appropriate controls over the transfer of information relating to accounting estimates into the general ledger, including appropriate controls over journal entries.

A53. In some entities, the term *governance* may be used to describe activities within the control environment, ***the entity's process to monitor the system of internal control, monitoring of controls,*** and other components of ***the system of*** internal control, as described in AU-C section 315.³³

³³ [Footnote omitted for purposes of this proposed SAS.]

A54. For entities with an internal audit function, its work may be particularly helpful to the auditor in obtaining an understanding of the following:

- The nature and extent of management's use of accounting estimates
- The design and implementation of ***controls control activities*** that address the risks related to the data, assumptions, and models used to make the accounting estimates
- The aspects of the entity's information system that generate the data on which the accounting estimates are based
- How new risks relating to accounting estimates are identified, assessed, and managed

Reviewing the Outcome or Re-Estimation of Previous Accounting Estimates (Ref: par. 13)

A55. A review of the outcome or re-estimation of previous accounting estimates (retrospective review) assists in identifying and assessing the risks of material misstatement when previous accounting estimates have an outcome through transfer or realization of the asset or liability in the current period or are re-estimated for the purpose of the current period. Through performing a retrospective review, the auditor may obtain the following:

- Information regarding the effectiveness of management’s previous estimation process, from which the auditor can obtain audit evidence about the likely effectiveness of management’s current process.
- Audit evidence of matters, such as the reasons for changes that may be required to be disclosed in the financial statements.
- Information regarding the complexity, subjectivity, or estimation uncertainty pertaining to the accounting estimates.
- Information regarding the susceptibility of accounting estimates to, or that may be an indicator of, possible management bias. The auditor’s professional skepticism assists in identifying such circumstances or conditions and in determining the nature, timing, and extent of further audit procedures.

A56. A retrospective review may provide audit evidence that supports the identification and assessment of the risks of material misstatement in the current period. Such a retrospective review may be performed for accounting estimates made for the prior period’s financial statements or may be performed over several periods or a shorter period (such as half-yearly or quarterly). In some cases, a retrospective review over several periods may be appropriate when the outcome of an accounting estimate is resolved over a longer period, *or when a history of outcomes provides meaningful information or evidence of a trend.*

A57. A retrospective review of management judgments and assumptions related to significant accounting estimates is required by AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*.³⁴ As a practical matter, the auditor’s review of previous accounting estimates as a risk assessment procedure in accordance with this SAS may be carried out in conjunction with the review required by AU-C section 240.

³⁴ [Footnote omitted for purposes of this proposed SAS.]

A58. Based on the auditor’s previous assessment of the risks of material misstatement, for example, if inherent risk is assessed as higher for one or more risks of material misstatement, the auditor may judge that a more detailed retrospective review is required. As part of the detailed retrospective review, the auditor may pay particular attention, when practicable, to the effect of data and significant assumptions used in making the previous accounting estimates. On the other hand, for example, for

accounting estimates that arise from the recording of routine and recurring transactions, the auditor may judge that the application of analytical procedures as risk assessment procedures is sufficient for purposes of the review.

A59. The measurement objective for fair value accounting estimates and other accounting estimates, based on current conditions at the measurement date, deals with perceptions about value at a point in time, which may change significantly and rapidly as the environment in which the entity operates changes. The auditor may, therefore, focus the review on obtaining information that may be relevant to identifying and assessing risks of material misstatement. For example, in some cases, obtaining an understanding of changes in market participant assumptions that affected the outcome of a previous period's fair value accounting estimates may be unlikely to provide relevant audit evidence. In this case, audit evidence may be obtained by understanding the outcomes of assumptions (such as a cash flow projection) and understanding the effectiveness of management's prior estimation process that supports the identification and assessment of the risk of material misstatement in the current period.

A60. A difference between the outcome of an accounting estimate and the amount recognized in the previous period's financial statements does not necessarily represent a misstatement of the previous period's financial statements. For example, an entity assumed a forecasted unemployment rate in the development of a loan loss estimate, and the actual losses and unemployment rate differed from that assumed. A difference may represent a misstatement if, for example, the difference arises from information that was available to management when the previous period's financial statements were finalized or that could reasonably be expected to have been obtained and taken into account in the context of the applicable financial reporting framework.³⁵ Such a difference may call into question management's process for taking information into account in making the accounting estimate. As a result, the auditor may need to reconsider their risk assessment or may determine that more persuasive audit evidence needs to be obtained about the matter. Many financial reporting frameworks contain guidance on distinguishing between changes in accounting estimates that constitute misstatements and changes that do not, and the accounting treatment required to be followed in each case.

[No proposed amendment to paragraphs .A61-.A63. Paragraph A67, A69, and A71 included for contextual purposes only.]

Identifying and Assessing the Risks of Material Misstatement (Ref: par. 4 and 15)

A64. Identifying and assessing risks of material misstatement at the relevant assertion level relating to accounting estimates includes not only accounting estimates that are recognized in the financial statements but also those that are included in the notes to the financial statements.

³⁵ [Footnote omitted for purposes of this SAS.]

A65. ~~AU-C section 200³⁸ states that GAAS does not ordinarily refer to inherent risk and control risk separately. However, this SAS AU-C section 315 requires a separate assessment of inherent risk and control risk to provide a basis for designing and performing further audit procedures to respond to the risks of material misstatement at the assertion level,⁴ including significant risks, at the relevant assertion level for accounting estimates in accordance with AU-C section 330.³⁹ See paragraphs A148–A149 of this section SAS for discussion about documentation of inherent risk factors.~~

A66. As discussed in paragraph 4 of this ~~section SAS~~, AU-C section 200⁴⁰ explains that inherent risk is **influenced by inherent risk factors**. ~~higher for some assertions and related classes of transactions, account balances, and disclosures than for others. In identifying the risks of material misstatement and in assessing inherent risk for accounting estimates in accordance with AU-C section 315, the auditor is required to take into account the inherent risk factors that affect susceptibility to misstatement of assertions, and how they do so. the degree to which the accounting estimate is subject to or affected by estimation uncertainty, complexity, subjectivity, or other inherent risk factors.~~ The auditor's consideration of the inherent risk factors may also provide information to be used in ~~determining~~ the following:

- **Assessing the likelihood and magnitude of misstatement (such as, where ~~where~~ inherent risk is assessed on the spectrum of inherent risk); and**
- **Determining the ~~the~~ reasons for the assessment given to the risks of material misstatement at the relevant assertion level, and that the auditor's further audit procedures in accordance with paragraph 18 of this SAS are responsive to those reasons**

The interrelationships between the inherent risk factors are further explained in appendix A.

⁴⁰ [Footnote omitted for purposes of this proposed SAS.]

A67. The reasons for the auditor's assessment of inherent risk at the relevant assertion level may result from one or more of the inherent risk factors of estimation uncertainty, complexity, subjectivity, or other inherent risk factors. Examples follow:

- Accounting estimates of expected credit losses are likely to be complex because the expected credit losses cannot be directly observed and may require the use of a complex model. The model may use a complex set of historical data and assumptions about future developments in a variety of entity-specific scenarios that may be difficult to predict. Accounting estimates for expected credit losses are also likely to be subject to high estimation uncertainty and significant

³⁸ [Footnote omitted for purposes of this SAS.]

⁴ Paragraphs 31 and 34 of AU-C section 315. [Subsequent footnotes renumbered]

³⁹ Paragraph .07b of AU-C section 330.

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subjectivity in making judgments about future events or conditions. Similar considerations apply to insurance contract liabilities.

- An accounting estimate for an obsolescence provision for an entity with a wide range of different inventory types may require complex systems and processes but may involve little subjectivity, and the degree of estimation uncertainty may be low, depending on the nature of the inventory.
- Other accounting estimates may not be complex to make but may have high estimation uncertainty and require significant judgment, for example, an accounting estimate that requires a single critical judgment about a liability, the amount of which is contingent on the outcome of the litigation.

A68 The relevance and significance of inherent risk factors may vary from one estimate to another. Accordingly, the inherent risk factors may, either individually or in combination, affect simple accounting estimates to a lesser degree, and the auditor may identify fewer risks or assess inherent risk *close to* at the lower end of the spectrum of inherent risk.

A69. Conversely, the inherent risk factors may, either individually or in combination, affect complex accounting estimates to a greater degree and may lead the auditor to assess inherent risk at the higher end of the spectrum of inherent risk. For these accounting estimates, the auditor's consideration of the effects of the inherent risk factors is likely to directly affect the number and nature of identified risks of material misstatement, the assessment of such risks, and ultimately, the persuasiveness of the audit evidence needed in responding to the assessed risks. Also, for these accounting estimates, the auditor's application of professional skepticism may be particularly important.

A70. Events occurring after the date of the financial statements may provide additional information relevant to the auditor's assessment of the risks of material misstatement at the relevant assertion level. For example, the outcome of an accounting estimate may become known during the audit. In such cases, the auditor may assess or revise the assessment of the risks of material misstatement at the relevant assertion level,⁴¹ regardless of *how* the *inherent risk factors affect susceptibility of assertions to misstatement relating to* degree to which the accounting estimate. was subject to or affected by estimation uncertainty, complexity, subjectivity, or other inherent risk factors. Events occurring after the date of the financial statements also may influence the auditor's selection of the approach to testing the accounting estimate in accordance with paragraph 18. For example, for a simple bonus accrual that is based on a straightforward percentage of compensation for selected employees, the auditor may conclude that there is relatively little complexity or subjectivity in making the accounting estimate and, therefore, may assess inherent risk at the relevant assertion level *close to* at the lower end of the spectrum of inherent risk. The payment of the

⁴¹ Paragraph .37-32 of AU-C section 315.

bonuses subsequent to period-end may provide sufficient appropriate audit evidence regarding the assessed risks of material misstatement at the relevant assertion level.

A71. The auditor's assessment of control risk may be done in different ways depending on preferred audit techniques or methodologies. The control risk assessment may be expressed using qualitative categories (for example, control risk assessed as maximum, moderate, or minimum) or in terms of the auditor's expectation of how effective the controls are in addressing the identified risk, that is, the planned reliance on the effective operation of controls. For example, if control risk is assessed as maximum, the auditor contemplates no reliance on the effective operation of controls. If control risk is assessed at less than maximum, the auditor contemplates reliance on the effective operation of controls.

[No amendment to paragraphs .A72-.A78.]

Other Inherent Risk Factors (Ref: par. 15b)

A79. The degree of subjectivity associated with an accounting estimate influences the susceptibility of the accounting estimate to misstatement due to management bias or ~~fraud~~ ***other fraud risk factors insofar as they affect inherent risk***. For example, when an accounting estimate is subject to a high degree of subjectivity, the accounting estimate is likely to be more susceptible to misstatement due to management bias or fraud, and this may result in a wide range of possible measurement outcomes. Management may select a point estimate from that range that is inappropriate in the circumstances, or that is inappropriately influenced by unintentional or intentional management bias, and that is, therefore, misstated. For continuing audits, indicators of possible management bias identified during the audit of preceding periods may influence the planning and risk assessment procedures in the current period.

[No amendment to paragraphs .A80-.A84.]

When the Auditor Intends to Rely on the Operating Effectiveness of ~~Relevant~~ Controls (Ref: par. 18)

A85. Testing the operating effectiveness of ~~relevant~~ controls may be appropriate when inherent risk is assessed as higher on the spectrum of inherent risk, including for significant risks. This may be the case when the accounting estimate is subject to or affected by a high degree of complexity. When the accounting estimate is affected by a high degree of subjectivity and, therefore, requires significant judgment by management, inherent limitations in the effectiveness of the design of controls may lead the auditor to focus more on substantive procedures than on testing the operating effectiveness of controls.

[No further amendments to AU-C section 540]

AU-C section 550, *Related Parties*

[No amendment to paragraphs .01–.A6.]

.A7 Matters that may be addressed in the discussion among the engagement team include the following:

- The nature and extent of the entity’s relationships and transactions with related parties (using, for example, the auditor’s record of identified related parties updated after each audit)
- An emphasis on the importance of maintaining professional skepticism throughout the audit regarding the potential for material misstatement associated with related party relationships and transactions
- The circumstances or conditions of the entity that may indicate the existence of related party relationships or transactions that management has not identified or disclosed to the auditor (for example, a complex organizational structure, use of entities formed to accomplish specific purposes,^{fn 22} or an inadequate information system)
- The records or documents that may indicate the existence of related party relationships or transactions
- The importance that management and those charged with governance attach to the identification of, appropriate accounting for, and disclosure of related party relationships and transactions and the related risk of management override of ~~relevant~~ controls

²² [Footnote omitted for purposes of this proposed SAS.]

[No amendment to paragraphs .A8–.A9.]

.A10 However, if the entity does not have such information systems in place, management may not be aware of the existence of all related parties. Nevertheless, the requirement to make the inquiries specified by [paragraph .14](#) still applies because management may be aware of parties that meet the related party definition set out in GAAP. In such a case, however, the auditor’s inquiries regarding the identity of the entity’s related parties are likely to form part of the auditor’s risk assessment procedures and related activities performed in accordance with section 315 to obtain information

regarding *the entity's organizational structure, ownership, governance, and business model*.²³ the following:

- ~~The entity's ownership and governance structures~~
- ~~The types of investments that the entity is making and plans to make~~
- ~~The way the entity is structured and how it is financed~~

In the particular case of common control relationships, because management is more likely to be aware of such relationships if they have economic significance to the entity, the auditor's inquiries are likely to be more effective if they are focused on whether parties with which the entity engages in significant transactions or shares resources to a significant degree are related parties.

²³ [Footnote omitted for purposes of this proposed SAS.]

[No amendment to paragraphs .A11–.A20.]

.A21 *Considerations specific to smaller entities.* Controls activities in smaller entities are likely to be less formal, and smaller entities may have no documented processes for dealing with related party relationships and transactions. An owner-manager may mitigate some of the risks arising from related party transactions or potentially increase those risks through active involvement in all the main aspects of the transactions. For such entities, the auditor may obtain an understanding of the related party relationships and transactions, and any controls that may exist over these, through inquiry of management combined with other procedures, such as observation of management's oversight and review activities and inspection of available relevant documentation.

[No amendment to paragraphs .A22–.A29.]

.A30 Relevant related party information shared with the engagement team members may include the following:

- The nature of the related party relationships and transactions
- Significant or complex related party relationships or transactions that may *be determined to be significant risks* ~~require special audit consideration~~, particularly transactions in which management or those charged with governance are financially involved

The exchange of information is most useful if made at an early stage of the audit.

[No amendment to paragraphs .A31–.A37.]

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.A38 Depending upon the results of the auditor's risk assessment procedures, the auditor may consider it appropriate to obtain audit evidence without testing the entity's controls over related party relationships and transactions. In some circumstances, however, it may not be possible to obtain sufficient appropriate audit evidence from substantive audit procedures alone, regarding the risks of material misstatement associated with related party relationships and transactions. For example, when intragroup transactions between the entity and its components are numerous and a significant amount of information regarding these transactions is initiated, authorized, recorded, processed, or reported electronically in an integrated system, the auditor may determine that it is not possible to design effective substantive audit procedures that by themselves would reduce the risks of material misstatement associated with these transactions to an acceptably low level. In such a case, in meeting the requirement of section 330 to obtain sufficient appropriate audit evidence about the operating effectiveness of relevant controls, the auditor is required to test the entity's controls over the completeness and accuracy of the recording of the related party relationships and transactions.

[No further amendment to AU-C section 550.]

AU-C section 600, *Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors)*

[No amendment to paragraphs .01–.19.]

.20 The auditor is required to identify and assess the risks of material misstatement through obtaining an understanding of the entity and its environment, *the applicable reporting framework and the system of internal control*.^{fn7} The group engagement team should

- a. enhance its understanding of the group, its components, and their environments, including group-wide controls, obtained during the acceptance or continuance stage.
- b. obtain an understanding of the consolidation process, including the instructions issued by group management to components. (Ref: [par. .A31–.A37](#))

^{fn7} [Footnote omitted for purposes of this proposed SAS.]

[No amendment to paragraphs .21–.A6.]

.A7 The group engagement team also may identify a component as likely to include significant risks of material misstatement of the group financial statements due to its specific nature or circumstances. ~~(that is, risks that require special audit consideration~~^{fn14}). For example, a component could be responsible for foreign exchange trading and, thus, expose the group to a significant risk of material misstatement, even though the

component is not otherwise of individual financial significance to the group.

^{fn 14} [Footnote omitted for purposes of this proposed SAS.]

[No amendment to paragraphs .A7–.A93.]

.A94 The examples provided cover a broad range of matters; however, not all matters are relevant to every group audit engagement, and the list of examples is not necessarily complete.

Group-Wide Controls

- Group-wide controls may include a combination of the following:
- Regular meetings between group and component management to discuss business developments and review performance
- Monitoring of components' operations and their financial results, including regular reporting routines, which enables group management to monitor components' performance against budgets and take appropriate action
- Group management's risk assessment process (that is, the process for identifying, analyzing, and managing business risks, including the risk of fraud, that may result in material misstatement of the group financial statements)
- Monitoring, controlling, reconciling, and eliminating intragroup account balances, transactions, and unrealized profits or losses at group level
- A process for monitoring the timeliness and assessing the accuracy and completeness of financial information received from components
- A central IT system controlled by the same general IT controls for all or part of the group
- Controls activities within an IT system that are common for all or some components
- *Controls within the group's process to monitor the system of internal controls, including activities of the internal audit function and self-assessment programs*
- Consistent policies and procedures, including a group financial reporting procedures manual
- Group-wide programs, such as codes of conduct and fraud prevention programs
- Arrangements for assigning authority and responsibility to component management

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- The internal audit function may be regarded as part of group-wide controls, for example, when the function is centralized. [Section 610](#), *Using the Work of Internal Auditors*, addresses the group engagement team's evaluation of whether the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of internal auditors, the level of competence of the internal audit function, and whether the function applies a systematic and disciplined approach when the group engagement team expects to use the function's work.^{fn1}

^{fn 1} [Footnote omitted for purposes of this proposed SAS.]

[No amendment to paragraph .A95.]

.A96 The following matters are relevant to the planning of the work of a component auditor:

- *[Required matters are italicized.]*
- *A request for the component auditor, knowing the context in which the group engagement team will use the work of the component auditor, to confirm that the component auditor will cooperate with the group engagement team*
- The timetable for completing the audit
- Dates of planned visits by group management and the group engagement team and dates of planned meetings with component management and the component auditor
- A list of key contacts
- *The work to be performed by the component auditor, the use to be made of that work, and arrangements for coordinating efforts at the initial stage of and during the audit, including the group engagement team's planned involvement in the work of the component auditor*
- *The ethical requirements that are relevant to the group audit and, in particular, the independence requirements*
- *In the case of an audit or review of the financial information of the component, component materiality*
- *In the case of an audit or review of, or specified audit procedures performed on, the financial information of the component, the threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements*
- *A list of related parties prepared by group management and any other related parties of which the group engagement team is aware and a request that the*

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component auditor communicates on a timely basis to the group engagement team related parties not previously identified by group management or the group engagement team

- Work to be performed on intragroup account balances, transactions, and unrealized profits or losses
- Guidance on other statutory reporting responsibilities (for example, reporting on group management's assertion on the effectiveness of internal control)
- When a time lag between completion of the work on the financial information of the components and the group engagement team's conclusion on the group financial statements is likely, specific instructions for a subsequent events review
- The following matters are relevant to the conduct of the work of the component auditor:
- The findings of the group engagement team's tests of controls ~~activities~~ of a processing system that is common for all or some components and tests of controls to be performed by the component auditor

...

[No further amendment to section 600.]

AU-C section 610, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*

[No amendment to paragraphs .01–.04.]

.05 Many entities establish internal audit functions as part of their internal control and governance structures. The objectives and scope of an internal audit function, the nature of its responsibilities, and its organizational status, including the function's authority and accountability, vary widely and depend on the size and structure of the entity and the requirements of management and those charged with governance. Section 315 addresses how the knowledge and experience of the internal audit function can inform the external auditor's understanding of the entity and its environment, ***the applicable financial reporting framework and the entity's system of internal control*** and identification and assessment of risks of material misstatement. Section 315^{fn1} also explains how effective communication between the internal and external auditors creates an environment in which the external auditor can be informed by the internal auditor of significant matters that may affect the external auditor's work.

^{fn1}[Footnote omitted for purposes of this proposed SAS.]

[No amendment to paragraphs .06–.A2.]

.A3 However, those in the entity with operational and managerial duties and responsibilities outside of the internal audit function would ordinarily face threats to their objectivity that would preclude them from being treated as part of an internal audit function for the purpose of this section, although they may perform controls ~~activities~~ that can be tested in accordance with section 330.^{fn 7} For this reason, monitoring controls performed by an owner-manager would not be considered equivalent to an internal audit function.

^{fn 7} [Footnote omitted for purposes of the proposed SAS.]

[No amendment to paragraphs .A4–.A2.]

.A12 The application of a systematic and disciplined approach to planning, performing, supervising, reviewing, and documenting its activities distinguishes the activities of the internal audit function from other monitoring control activities that may be performed within the entity.

[No amendment to paragraphs .A13–.A25.]

.A26 As explained in section 315,^{fn 11} significant risks ~~require special audit consideration~~ **are risks assessed close to the upper end of the spectrum of inherent risk** and, therefore, the external auditor's ability to use the work of the internal audit function in relation to significant risks will be restricted to procedures that involve limited judgment. In addition, when the risks of material misstatement is other than low, the use of the work of the internal audit function in obtaining audit evidence alone is unlikely to reduce audit risk to an acceptably low level and eliminate the need for the external auditor to perform some tests directly.

^{fn 11} [Footnote omitted for purposes of this SAS.]

[No further amendment to section 610.]

AU-C section 620, *Using the Work of an Auditor's Specialist*

[No amendment to paragraphs .01–.A4.]

.A5 An auditor's specialist may be needed to assist the auditor in one or more of the following:

- Obtaining an understanding of the entity and its environment, **the applicable financial reporting framework and the ~~including~~ the entity's system of** internal control
- Identifying and assessing the risks of material misstatement

- Determining and implementing overall responses to assessed risks at the financial statement level
- Designing and performing additional audit procedures to respond to assessed risks at the relevant assertion level, which may comprise tests of controls or substantive procedures
- Evaluating the sufficiency and appropriateness of audit evidence obtained in forming an opinion on the financial statements

[No further amendment to section 620.]

AU-C section 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

[No amendment to paragraphs .01 –.A17]

.A18 Section 315 defines a *significant risk* as an identified ~~and assessed~~ risk of material misstatement *for which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk due to the degree to which the inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur that, in the auditor's judgment, requires special audit consideration.*^{fn 13} Areas of significant management judgment and significant unusual transactions may often be identified as significant risks. Significant risks are therefore often areas that require significant auditor attention.

^{fn 13} See paragraph 13 of AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.

[Subsequent footnotes renumbered.]

[No further amendment to section 701.]

AU-C section 720, *Other Information in Documents Containing Audited Financial Statements*

[No amendment to paragraphs .01–.A33.]

.A34 The auditor's knowledge obtained in the audit includes the auditor's understanding of the entity and its environment, *the applicable financial reporting framework, and including the system of* entity's internal control, obtained in accordance with section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement.*^{fn 9} Section 315 sets out the auditor's required understanding, which includes such matters as obtaining an understanding of the following:

a. The entity's organizational structure, ownership and governance, and its business model, including the extent to which the business model integrates the use of IT

~~a.b.~~ The relevant industry, regulatory, and other external factors

~~b.~~ The nature of the entity

~~c.~~ The entity's selection and application of accounting policies

~~d.~~ The entity's objectives and strategies

~~e.c.~~ The *relevant measures used, internally and externally, to assess measurement and review* of the entity's financial performance

~~f.d.~~ The entity's internal control

^{fn 9} [Footnote omitted for purposes of this proposed SAS.]

[No amendment to paragraphs .A34-. A54.]

.A55 In reading the other information, the auditor may become aware of new information that has implications for the following:

- The auditor's understanding of the entity and its environment, *the financial reporting framework and the entity's system of internal control* which may indicate the need to revise the auditor's risk assessment ^{fn 12}
- The auditor's responsibility to evaluate the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements ^{fn 13}
- The auditor's responsibilities relating to subsequent events

^{fn 12 and fn 13} [Footnotes omitted for purposes of this proposed SAS.]

[No further amendment to section 720.]

AU-C section 930, *Interim Financial Information*

[No amendment to paragraphs .01-.10.]

Procedures for a Review of Interim Financial Information

Understanding the Entity and Its Environment, *the Applicable Financial Reporting Framework, including Its the Entity's System of Internal Control*

.11 To plan and conduct the engagement, the auditor should have an understanding of the entity and its environment, *the applicable financial reporting framework, including*

~~its~~ **the entity's system of** internal control as it relates to the preparation and fair presentation of both annual and interim financial information, sufficient to be able to

- a. identify the types of potential material misstatements in the interim financial information and consider the likelihood of their occurrence.
- b. select the inquiries and analytical procedures that will provide the auditor with a basis for reporting whether the auditor is aware of any material modifications that should be made to the interim financial information for it to be in accordance with the applicable financial reporting framework.

[No amendment to paragraphs .12–.A6.]

Procedures for a Review of Interim Financial Information

Understanding the Entity and Its Environment, **the Applicable Financial Reporting Framework**, ~~including its~~ ~~the entity's~~ Internal Control (Ref: [par. .11–.12](#))

.A7As required by section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, the auditor who has audited the entity's financial statements for one or more annual periods would have obtained an understanding of the entity and its environment, **the applicable financial reporting framework**, ~~including its~~ ~~the entity's~~ internal control as it relates to the preparation and fair presentation of annual financial information, that was sufficient to conduct the audit. Internal control over the preparation and fair presentation of interim financial information may differ from internal control over the preparation and fair presentation of annual financial statements because certain accounting principles and practices used for interim financial information may differ from those used for the preparation of annual financial statements (for example, the use of estimated effective income tax rates for the preparation of interim financial information).

[No amendment to paragraphs .A8–.A10.]

Analytical Procedures, Inquiries, and Other Review Procedures

Analytical Procedures (Ref: [par. .13](#))

.A11 Procedures for conducting a review of interim financial information generally are limited to analytical procedures, inquiries, and other procedures that address significant accounting and disclosure matters relating to the interim financial information. The auditor's understanding of the entity and its environment, **the applicable financial reporting framework**, ~~including its~~ ~~the entity's~~ ~~including its~~ internal control, the results of the risk assessments relating to the preceding audit, and the auditor's consideration of materiality as it relates to the interim financial information, influences the nature and extent of the inquiries made and analytical procedures performed. For example, if the auditor becomes aware of a significant change in the entity's control activities at a particular location, the auditor may consider the following procedures:

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- Making additional inquiries, such as whether management monitored the changes and considered whether they were operating as intended
- Employing analytical procedures with a more precise expectation

[No further amendments to AU-C section 930.]

AU-C section 935, *Compliance Audits*

[No amendment to paragraphs .01–.A13.]

.A14 Performing risk assessment procedures to obtain an understanding of the entity’s internal control over compliance includes an evaluation of the design of controls and whether the controls have been implemented. Internal control consists of the following five interrelated components: the control environment, the entity’s risk assessment *process*, information and communication systems, control activities, and *the entity’s process to monitoring the system of internal control*.^[fn 12] Section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, contains a detailed discussion of these components.

[No further amendments to AU-C section 935.]

AU-C section 940, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements*

[No amendment to paragraphs .01–.26.]

.26 The auditor should identify significant classes of transactions, account balances, and disclosures, and their relevant assertions. To identify significant classes of transactions, account balances, and disclosures, and their relevant assertions, the auditor should evaluate the qualitative and quantitative *inherent* risk factors related to the financial statement line items and disclosures. (Ref: par. .A50–.A52)

[No amendment to paragraphs .26–.30.]

.31 The auditor should understand how IT affects the entity’s flow of transactions and, as required by section 315, *Understanding the Entity and Its Environment* and

^[fn 12][Footnote deleted, October 2011, to reflect conforming changes necessary due to the issuance of SAS No. 122. Footnote renumbered, October 2011, to reflect conforming changes necessary due to the issuance of SAS No. 123. Footnote subsequently renumbered by the issuance of SAS No. 125, December 2011.]

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Assessing the Risks of Material Misstatement, ~~how the entity has responded to the~~ **entity's general information technology (IT) controls that address the** risks arising from **the use of IT.**^{fn 6} (Ref: par. .A58)

^{fn 6} Paragraph ~~22-26(c)~~ of ~~section 315~~ **the proposed SAS, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement.**

[No amendment to paragraphs .32--.56.]

.57 In an audit of ICFR, the auditor should obtain written representations from management

- a. acknowledging management's responsibility for ~~establishing~~ **designing, implementing,** and maintaining effective ICFR;
- b. stating that management has performed an assessment of the effectiveness of the entity's ICFR and specifying the criteria;
- c. stating that management did not use the auditor's procedures performed during the integrated audit as part of the basis for management's assessment about ICFR;
- d. stating management's assessment about the effectiveness of the entity's ICFR based on the criteria as of a specified date;
- e. stating that management has disclosed to the auditor all deficiencies in the design or operation of ICFR, including separately disclosing to the auditor all such deficiencies that it believes to be significant deficiencies or material weaknesses;
- f. describing any fraud resulting in a material misstatement to the entity's financial statements and any other fraud that does not result in a material misstatement to the entity's financial statements, but involves senior management or management or other employees who have a significant role in the entity's ICFR;
- g. stating whether the significant deficiencies and material weaknesses identified and communicated to management and those charged with governance during previous engagements pursuant to paragraph .59 have been resolved and specifically identifying any that have not; and
- h. stating whether there were, subsequent to the date being reported on, any changes in ICFR or other conditions that might significantly affect ICFR, including any corrective actions taken by management with regard to significant deficiencies and material weaknesses (Ref: par. .A103)

[No amendment to paragraphs .58--.A25.]

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.A26 The extent of the procedures necessary to obtain the understanding required by paragraph .18 will vary, depending on the nature of those activities. In performing risk assessment procedures, the auditor is required to inquire of appropriate individuals within the internal audit function (if such function exists).^{fn 15} Section 315 provides guidance with respect to such inquiries and certain additional procedures based on the responses to such inquiries.^{fn 16}

^{fn 15} Paragraph ~~.06~~ **14** of section 315. [Footnote renumbered by the issuance of SAS No. 140, April 2020.]

^{fn 16} Paragraph ~~A9–A13–A25 and Appendix 4~~ of section 315. [Footnote renumbered by the issuance of SAS No. 140, April 2020.]

[No amendment to paragraphs .A26–.A20.]

.A21 Evaluating whether the following matters are important to the entity's financial statements and ICFR and, if so, how they may affect the auditor's procedures may assist the auditor in planning the audit of ICFR:

- Knowledge of the entity's ICFR obtained during other engagements performed by the auditor or, if applicable, during a review of a predecessor auditor's working papers
- Matters affecting the industry in which the entity operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes
- Matters relating to the entity's business, including its organization, operating characteristics, and capital structure
- The extent of recent changes, if any, in the entity, its operations, or its ICFR
- The auditor's preliminary judgments about financial statement materiality, risk, and other factors relating to the determination of material weaknesses
- Deficiencies previously communicated to those charged with governance or management
- Legal or regulatory matters of which the entity is aware
- The type and extent of available evidence related to the effectiveness of the entity's ICFR
- Preliminary judgments about the effectiveness of ICFR
- Public information about the entity relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of the entity's ICFR

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- Knowledge about risks related to the entity evaluated as part of the auditor's ***procedures regarding acceptance or continuance of the client relationship or the integrated audit engagement acceptance and retention evaluation.***
- The relative complexity of the entity's operations

[No amendment to paragraphs .A22–.A24.]

.A25 Section 240 addresses the auditor's identification and assessment of the risks of material misstatement due to fraud.^{fn 14} Controls that might address these risks include

- controls over significant unusual transactions, particularly those that result in late or unusual journal entries;
- controls over journal entries and adjustments made in the period-end financial reporting process;
- controls over related party transactions;
- controls related to significant ~~management~~ ***accounting*** estimates; and

[No amendment to paragraphs .A26–.A32.]

.A33 A top-down approach involves

- beginning at the financial statement level;
- using the auditor's understanding of the overall risks to ICFR;
- focusing on entity-level controls;
- working down to significant classes of transactions, account balances, and disclosures, and their relevant assertions, ***which directs attention to classes of transactions, accounts, disclosures, and assertions that present a reasonable possibility of material misstatement of the financial statements;***
- ~~directing attention to classes of transactions, accounts, disclosures, and assertions that present a reasonable possibility of material misstatement of the financial statements;~~
- verifying the auditor's understanding of the risks in the entity's processes; and

^{fn 14} [Paragraphs .25–.27](#) of section 240. [Footnote renumbered by the issuance of SAS No. 140, April 2020.]

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- selecting controls for testing that sufficiently address the assessed risk of material misstatement to each relevant assertion.

[No amendment to paragraphs .A34–.A49.]

A50 *Inherent* risk factors **are** relevant to the identification of significant classes of transactions, account balances, and disclosures, and their relevant assertions ~~include~~. *Inherent risk factors may be qualitative or quantitative and affect the susceptibility of assertions to misstatement. Inherent risk factors are described in section 315.*

- ~~size and composition of the account;~~
- ~~susceptibility to misstatement due to errors or fraud;~~
- ~~volume of activity, complexity, and homogeneity of the individual transactions processed through the account or reflected in the disclosure;~~
- ~~nature of the account, class of transactions, or disclosure;~~
- ~~accounting and reporting complexities associated with the account, class of transactions, or disclosure;~~
- ~~exposure to losses in the account;~~
- ~~possibility of significant contingent liabilities arising from the activities reflected in the account or disclosure;~~
- ~~existence of related party transactions in the account; and~~
- ~~changes from the prior period in the account, class of transactions, or disclosure characteristics.~~

.A51 The *inherent* risk factors ~~in paragraph .26~~ that the auditor is required to evaluate in the identification of significant classes of transactions, account balances, and disclosures, and their relevant assertions, are the same in the audit of ICFR as in the audit of the financial statements; accordingly, significant classes of transactions, account balances, and disclosures, and their relevant assertions, are the same in an integrated audit.