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Substantive Procedures Required in Every Audit

Because of the judgmental nature of the auditor's risk assessments and the inherent limitations of internal control, particularly the risk of management override, the auditing standards prescribe certain substantive procedures that should be performed in every audit. The additional substantive procedures that are needed in particular circumstances depend on the auditor's judgment about the sufficiency and appropriateness of audit evidence in the circumstances.

Material Account Balance, Transaction Class, or Disclosure

Risk assessment procedures and test of controls contribute to the formation of the auditor's opinion, but don't by themselves provide sufficient, appropriate audit evidence. According to AU-C 330.18, no matter what the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions for each material class of transactions, account balance, and disclosure. The reasons for this requirement are as follows:

- The auditor's assessment of risk is judgmental and might not be sufficiently precise to identify all risks of material misstatement.
- There are inherent limitations on the effectiveness of internal control, including management override, and even effective internal controls reduce, but don't eliminate, risks of material misstatement.

The requirement to perform substantive procedures for all relevant assertions for each material class of transactions, account balance, and disclosure is missed sometimes by auditors. In the PPC audit methodology, an audit area is considered significant if it contains a significant transaction class, *material account balance*, fraud risk or other significant risk, or requires significant disclosures. (The existence of a material account balance or disclosure in an audit area is enough by itself to make the audit area a significant audit area.) If an audit area is considered significant, an audit program (using the

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Basic or Extended audit approach) that includes substantive procedures is always recommended, regardless of the combined risk of material misstatement (RMM). As a result, the limited procedures approach isn't appropriate for significant audit areas.

Financial Close and Reporting Process

AU-C 330.21 requires that the auditor perform the following substantive procedures related to the financial close and reporting process in every audit:

- Agree or reconcile the financial statements, including the accompanying notes, to the underlying accounting records. AU-C 330.33 requires that the auditor's documentation demonstrate that agreement or reconciliation.
- Examine material journal entries and other adjustments made during the course of preparing the financial statements.

Practical Consideration:

SAS 134 amended AU-C 330.21 to agree or reconcile information in the financial statements, including disclosures, with the underlying accounting records whether such information is obtained from within or outside of the general and subsidiary ledgers. SAS 134 also amended AU-C 330.33 to require the auditor to document such procedures.

Management Override of Controls

AU-C 240.32, as amended by SAS 135, requires certain substantive procedures in all audits to address the risk of management override of controls. These required procedures are as follows:

- Examine journal entries and other adjustments for evidence of possible material misstatement due to fraud, including—
    - Obtaining an understanding of the financial reporting process and controls over journal entries and other adjustments, and the suitability of design and implementation of those controls.
    - Inquiring of employees involved in the financial reporting process about inappropriate or unusual journal entry activity related to the processing of journal entries and other adjustments.
    - Considering fraud risk factors, the nature and complexity of accounts, and unusual entries processed.
    - Selecting journal entries and other adjustments made at the end of the reporting period.
    - Considering the need to test journal entries and other adjustments made throughout the period.
- Review accounting estimates for biases that could result in material misstatement due to fraud, including—
    - Evaluating whether management's judgments and decisions, even if they are individually reasonable, indicate possible bias that may represent a material misstatement due to fraud and, if so, reevaluating the accounting estimates.
    - Performing a retrospective review of management's judgments and assumptions related to significant prior-year accounting estimates.

Practical Consideration:

In August 2019, the AICPA issued an exposure draft of a proposed SAS, *Auditing Accounting Estimates and Related Disclosures*. The proposed SAS would supersede AU-C 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*. It would also amend a number of other AU-C sections. The effective date, as proposed, would be for audits of financial statements for periods ending on or after December 15, 2022. Auditors can follow this project at **www.aicpa.org**.

- Evaluate the business purpose (or lack thereof) of significant unusual transactions, including—
    - Reading the documentation for the transaction and evaluating whether the information is consistent with explanations obtained from inquiries and other audit evidence about the transaction's business purpose (or lack thereof).
    - Determining whether the entity's policies and procedures for authorization and approval of the transaction were followed.
    - Evaluating whether significant unusual transactions identified by the auditor have been properly accounted for and disclosed in the financial statements.

Significant Risks

Significant risks, which include fraud risks, are risks that require special audit attention because of the nature of the risk or the likelihood and potential magnitude (including quantitative and qualitative considerations) of related misstatements. When considering if an identified risk is a significant risk, determine if it relates to (1) significant economic, accounting, or other developments needing specific attention; (2) complex transactions; (3) significant related-party transactions; (4) measurements that are subjective or uncertain, especially estimates with a high degree of uncertainty; or (5) significant unusual transactions. Related-party transactions that are also significant unusual transactions are also treated as significant risks.

When the audit approach to significant risks consists only of substantive procedures (that is, the auditor doesn't plan to rely on controls), the substantive procedures should be tests of details only or a combination of tests of details and substantive analytical procedures. The use of only substantive analytical procedures isn't permitted.

Other Specific Requirements

There are also other presumptively mandatory requirements for substantive procedures for particular account balances. Examples include the following:

- Confirmation of accounts receivable.
- Inventory observation; that is, being present at the time of the count and, by suitable observation, tests, and inquiries being satisfied about the effectiveness of the methods of inventory taking.

In addition, there are other specific requirements to perform procedures, typically called general procedures, that don't relate to particular account balances, such as performing a review for subsequent events and reading minutes of meetings of directors.

Documentation

AU-C 330.30 and AU-C 240.44 require the auditor to document the following items relating to substantive procedures, including responses to fraud risks:

- The nature, timing, and extent of substantive procedures.
- The linkage of those procedures with the assessed risks at the relevant assertion level.
- The results of the procedures, including procedures to address the risk of management override of controls.

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FASB Simplifies the Accounting for Income Taxes

This past December, the FASB issued ASU 2019-12, *Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes*, as part of its ongoing Simplification Initiative to reduce complexity (and cost) in accounting standards. This article provides a brief description of the amendments, effective dates, and transition requirements based on the ASU's Summary.

ASU 2019-12 addresses several areas for simplification by doing the following:

- Requiring that an entity evaluate when a step up in the tax basis of goodwill should be considered part of the business combination in which the book goodwill was originally recognized and when it should be considered a separate transaction.
- Specifying that an entity isn't required to allocate the consolidated amount of current and deferred tax expense to a legal entity that isn't subject to tax in its separate financial statements. However, an entity may elect to do so (on an entity-by-entity basis) for a legal entity that is both not subject to tax and disregarded by the taxing authority.
- Requiring that an entity reflect the effect of an enacted change in tax laws or rates in the annual effective tax rate computation in the interim period that includes the enactment date.
- Requiring that an entity recognize a franchise tax (or similar tax) that is partially based on income as an income-based tax and account for any incremental amount incurred as a non-income-based tax.

The ASU also simplifies accounting for income taxes by eliminating the following:

- Exception to the general methodology for calculating income taxes in an interim period when a year-to-date loss exceeds the anticipated loss for the year.
- Exception to the requirement to recognize a deferred tax liability for equity method investments when a foreign subsidiary becomes an equity method investment.
- Exception to the ability not to recognize a deferred tax liability for a foreign subsidiary when a foreign equity method investment becomes a subsidiary.
- Exception to the incremental approach for intraperiod tax allocation when there is a loss from continuing operations and income or a gain from other items (for example, discontinued operations or other comprehensive income).

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The ASU also makes the following minor Codification improvements:

- Clarifies that for allocated and unallocated employee stock ownership plan shares, the tax benefit of tax-deductible dividends should be recognized in income taxes allocated to continuing operations.
- Corrects and clarifies the illustration at FASB ASC 323-740-55-8 regarding investments in qualified affordable housing projects accounted for by the equity method.

Effective Date and Transition

The guidance in ASU 2019-12 is effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2020. For all other entities, the guidance is effective for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. Early adoption is permitted for all entities, including adoption in any interim period for periods for which financial statements haven't yet been issued for public business entities or haven't yet been made available for issuance for all other entities. An entity that elects to early adopt the amendments in an interim period should reflect any adjustments as of the beginning of the annual period that includes that interim period. Additionally, an entity that elects early adoption must adopt all the amendments in the same period.

Transition should be applied as follows:

- **Either a retrospective basis for all periods presented or a modified retrospective basis through a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year of adoption**—amendments related to franchise taxes that are partially based on income.
- **Retrospective basis for all periods presented**—amendments concerning separate financial statements of legal entities that aren't subject to tax.
- **Modified retrospective basis through a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year of adoption**—amendments related to changes in ownership of foreign equity method investments or foreign subsidiaries.
- **Prospective basis**—all other amendments.

Practical Consideration:

The ASU is available at **www.fasb.org** and on Checkpoint at **checkpoint.riag.com**.