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| Experienced auditor | An individual (whether internal or external to the firm) who has practical audit experience and a reasonable understanding of audit processes, GAAS and applicable legal and regulatory requirements; the business environment in which the entity operates, and auditing and financial reporting issues relevant to the entity's industry. (Practical audit experience does not mean the auditor is required to have performed comparable audits.) |
| Report release date | Date the auditor grants the entity permission to use the auditor's report in connection with the financial statements.  |

## Requirements

The auditor is required to perform the following procedures related to audit documentation:

### *Timely Preparation of Audit Documentation*

1. Prepare audit documentation on a timely basis.

### *Documentation of Audit Procedures Performed and Audit Evidence Obtained*

2. Prepare audit documentation sufficient to enable an experienced auditor with no previous connection to the audit to understand (a) the nature, timing, and extent of the audit procedures performed to comply with GAAS and applicable legal and regulatory requirements; (b) the results of audit procedures performed and the audit evidence obtained; and (c) conclusions reached on significant audit findings and significant professional judgments made in reaching those conclusions.
3. To document the nature, timing, and extent of audit procedures performed, record (a) the identifying characteristics of the specific items or matters tested, (b) who performed the audit work and the date work was completed, and (c) who reviewed the audit work and the date and extent of the review.
4. Include in the audit documentation abstracts or copies of significant contracts or agreements that were inspected during the audit.
5. Document discussions of significant findings with management, those charged with governance, and others. Include the nature of the findings discussed, and when and with whom the discussions occurred.
6. If information was identified that is inconsistent with the auditor's final conclusion regarding a significant finding, document how the inconsistency was addressed.
7. Document the justification for any departure from a relevant presumptively mandatory requirement. Also document how the alternative audit procedures performed were sufficient to achieve the intent of that requirement.
8. Additional documentation is required for matters arising after the date of the auditor's report. Document (a) the circumstances encountered; (b) new or additional audit procedures performed, audit evidence obtained, conclusions reached, and their effect on the audit report; and (c) when and by who changes to the audit documentation were made and reviewed.

### *Assembly and Retention of the Final Audit File*

9. Document the report release date in the audit documentation.
10. Complete the administrative process of assembling the final audit file on a timely basis, no later than the documentation completion date (i.e., no later than 60 days following the report release date).
11. Do not discard any audit documentation after the documentation completion date before the end of the specified retention period, a minimum of five years from the report release date.
12. If audit documentation needs to be modified or added to after the documentation completion date, document the specific reasons for making the changes and when and by whom the changes were made and reviewed.

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**PUBLIC COMPANY IMPLICATION:** PCAOB Staff Audit Practice Alert No. 14 reminds auditors of the potentially severe sanctions associated with improperly altering audit documentation. Improper alteration, especially in connection with an inspection or investigation, violates the Board's rules. The Staff Audit Practice Alert emphasizes that AS 1215 (originally issued as AS 3) requires the completion of a complete and final set of audit documentation within 45 days of the report release date. After this date, audit documentation may not be deleted or discarded. Additional documentation may be added, if the additional documentation is dated, identified as to individual and reason for the addition. Registered firms have an obligation to ensure that work papers are properly archived, that no improper alterations occur after archival, and that PCAOB inspectors are provided originally-archived documentation, supplemented, if appropriate, with additions that meet the above criteria.

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## Analysis and Application of Procedures

### *Timely Preparation of Audit Documentation*

Timely preparation of audit documentation enhances audit quality and facilitates the effective review and evaluation of audit evidence obtained and conclusions reached before the auditor's report is finalized.

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**PLANNING AID REMINDER:** The report release date is often the date the auditor delivers the audit report to the entity. However, when there are delays in releasing the report, the auditor may become aware of a fact that might have affected the audit report if it was known. AU-C 561 addresses the auditor's responsibilities in such circumstances.

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### *Documentation of Audit Procedures Performed and Audit Evidence Obtained*

#### *Sufficiency of audit documentation for an experienced auditor*

The form, content, and extent of audit documentation will vary, and the following factors should be considered:

- Size and complexity of the entity,
- Identified risks of material misstatement,
- Degree of professional judgment required to perform the procedures and evaluate the results,

- Nature of audit procedures used,
- Significance of the audit evidence obtained,
- Nature and extent of identified exceptions,
- Need to document a conclusion (or the basis for a conclusion) that is not evident from reviewing the documentation of the work performed, and
- Audit methodology and tools used.

Audit documentation (which may be in hard-copy form, electronic form, or other medium) developed for an engagement should demonstrate that the three standards of fieldwork were satisfied. The documentation generally includes the following:

- Audit plans,
- Analyses,
- Issues memoranda,
- Confirmation letters,
- A representation letter,
- Checklists,
- Correspondence concerning and summaries of significant findings or issues, and
- Abstracts/copies of entity documents (including significant contracts or agreements that support the accounting for specific transactions).

The auditor is not required to include items such as superseded, incomplete, corrected, or duplicate documents in the audit documentation. The auditor also cannot rely on oral explanations to support the work performed or the conclusions reached, although oral explanations can supplement the audit documentation.

Compliance with AU-C 230 will generally result in sufficient, appropriate audit documentation; however, other AU-C sections contain specific documentation requirements applicable to particular circumstances (see Exhibit AU-C 230-1). Audit documentation serves to provide evidence that the audit complies with GAAS. However, the auditor is not required to document every matter considered during the audit. Furthermore, the auditor is not required to separately document compliance for matters for which the existing audit documentation demonstrates compliance; for example:

- An audit plan demonstrates the auditor has planned the audit.
- A signed engagement letter demonstrates the auditor's agreement to the terms of the audit engagement with management or those charged with governance.
- A qualified auditor's report demonstrates compliance with GAAS requirements to express a qualified opinion.

There are various ways compliance with general audit requirements can be demonstrated. For example, professional skepticism may be documented by evidence of specific procedures performed to corroborate management's re-

sponses to the auditor's inquiries. Engagement partner responsibility for the direction, supervision, and performance of the audit in compliance with GAAS may be documented by the partner's involvement in team discussions about the susceptibility of the entity's financial statements to material misstatements.

Significant audit findings or issues encountered during an engagement should be documented. The following are examples of significant findings or issues:

- Significant matters related to the selection, application, and consistency of significant accounting practices, particularly related to accounting for complex or unusual transactions and the accounting for items dependent on estimates, uncertainties, and management assumptions.
- Matters leading to significant risks.
- The results of audit procedures suggesting that the financial statements could be materially misstated.
- The results of audit procedures suggesting a need to revise the auditor's assessment of and response to the risks of material misstatement.
- The application of required audit procedures was difficult.
- Findings that could lead to a modification of the standard auditor's report.

The form, content, and extent of audit documentation regarding significant findings will vary depending on the extent of professional judgment exercised. It is appropriate for the auditor to document professional judgments when the findings, issues, and judgments are significant, as in the following circumstances:

- When considering information or factors that should be considered and the consideration is significant.
- When concluding as to the reasonableness of areas of subjective judgments.
- When concluding as to a document's authenticity when conditions caused the auditor to believe the document may not be authentic.

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**ENGAGEMENT STRATEGY:** The auditor may find it helpful to prepare a completion memorandum, or summary of the significant issues or findings identified during the audit and how they were addressed. This summary can facilitate effective and efficient reviews and inspections of the audit documentation as well as help the auditor identify any AU-C section objectives not being achieved that could prevent him or her from achieving the overall objectives of the auditor.

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In auditing smaller, less complex entities, audit documentation will generally be less extensive. However, documentation should still be sufficient for an experienced auditor to determine if a GAAS audit was performed, because the audit may be subject to external review.

*Identification of items tested and of the preparer and reviewer*

Documenting the identifying characteristics of items tested improves the auditor's ability to review and supervise work performed and to investigate excep-

tions and inconsistencies. For example, if 50 payroll transactions are tested as part of the tests of controls, the audit documentation must specifically identify which 50 items were tested possibly by listing the payroll check numbers. Likewise, if accounts are confirmed as part of the audit of receivables, the specific accounts confirmed must be documented.

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**PLANNING AID REMINDER:** In some instances, it is not necessary to specifically list each item tested. For example, if systematic sampling is used it is sufficient to identify the starting point and the sampling interval. However, the method of documentation must enable an experienced auditor to reconstruct which specific sample items were tested as part of the engagement.

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The requirement for documenting who reviewed audit work and the date and extent of the review does not require each individual working paper to contain evidence of its review. What must be documented is what audit work was reviewed, who reviewed the work, and when it was reviewed.

#### *Documentation of discussions of significant findings*

Documentation of discussions of significant findings with management, those charged with governance, or other personnel within or external to the entity such as those providing professional advice, is not limited to auditor-prepared documentation. Documentation may include documents such as entity-prepared minutes of meetings if they provide an appropriate record of the discussion.

#### *Documentation of inconsistencies*

Documentation of information identified that is inconsistent with the auditor's final conclusion may include procedures performed and documentation of consultations or resolutions of differences in professional judgment among the engagement team or between the engagement team and others consulted.

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**ENGAGEMENT STRATEGY:** Documentation as discussed in AU-C 230 is essential in supporting an auditor against claims of malpractice. Auditors should ensure that their audit procedures, results, and conclusions are well documented and carefully reviewed. Such steps are an important part of minimizing liability risk.

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#### *Documentation of departure from a relevant requirement*

GAAS requires the auditor to comply with requirements that are relevant to the audit. Accordingly, the auditor is only required to document departure from relevant requirements. Requirements are not relevant in cases where (1) the AU-C section is not relevant or (2) the requirement is conditional and the condition does not exist.

#### *Matters arising after the date of the auditor's report*

Circumstances in which the auditor performs audit procedures or draws new conclusions after the date of his or her report are rare, but they do occur. Such circumstances include when the auditor becomes aware of facts that existed at

the date of his or her report that might have caused the opinion in the report to be modified or the financial statements to be amended or when the auditor concludes necessary audit procedures were omitted.

#### *Assembly and Retention of the Final Audit File*

##### *Assembly of the audit file on a timely basis*

While 60 days is the normal period of time auditors have to complete assembling the audit file, auditors may have fewer than 60 days to complete this process due to statutes, regulations, or the firm's quality control policies. Prior to the documentation completion date, the auditor may change the audit documentation to:

- Complete the documentation and assembly of the audit evidence that was gathered prior to the date of the auditor's report,
- Assemble the audit file (e.g., delete or discard superseded documentation and cross-reference working papers),
- Sign off on file completion checklists, and
- Add information to the file received after the date of the auditor's report (e.g., an original of a confirmation that was previously faxed).

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**ENGAGEMENT STRATEGY:** The auditor is required to document auditor independence and staff training. The most efficient means of documenting these items may be centrally within the firm, although the firm can choose to include the documentation at the engagement level.

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##### *Retention of the audit file*

Audit documentation should be retained for a period of time that is sufficient to meet the quality control policies of the CPA firm, and any applicable legal or regulatory requirements, which may in some instances specify retention periods longer than five years.

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**PUBLIC COMPANY IMPLICATIONS:** The Sarbanes-Oxley Act of 2002 (SOX) required the PCAOB to adopt an auditing standard that requires auditors to prepare and maintain audit documentation for a period of at least seven years. The nature and extent of documentation retained must be in sufficient detail to support the auditor's conclusions. SOX makes the knowing and willful destruction of audit documentation within the seven-year period a criminal offense. The PCAOB's AS-1215 (*Audit Documentation*) contains the audit documentation requirements applicable to audits of public companies. The PCAOB states that a failure to prepare adequate audit documentation is serious, and inadequate audit documentation in a high-risk area is a *very serious* (authors' emphasis) violation of PCAOB standards. The PCAOB also states that an oral explanation of audit procedures without written documentary evidence is insufficient. In addition, audit documentation should be prepared at the time the audit procedure is performed. Failure to maintain sufficient documentation leads to the presumption that the procedures were not applied, the evidence was not obtained, and the conclusions reached lacked adequate support. AU-C 230 bears many similarities to AS-1215. In April 2016, the PCAOB issued Staff Audit Practice Alert No. 14

| Reference  | Nature of Documentation  |
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| AU-C 220, <i>Quality Control for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards</i> (paragraphs .25 and .26) | <p>Issues and conclusions reached related to compliance with ethical and independence requirements and acceptance and continuance of client relationships.</p> <p>The engagement quality reviewer should document that procedures required for the quality review have been performed, the date the review was completed, and that the reviewer is not aware of any unresolved matters that would cause him or her to believe that the significant judgments that the engagement team made and the conclusions it reached were not appropriate.</p>  |
| AU-C 240, <i>Consideration of Fraud in a Financial Statement Audit</i> (paragraphs .43-.46).   | <p>Document the audit team brainstorming discussion on fraud (when it occurred, who participated, what was discussed, conclusions reached).</p> <p>Procedures performed to identify and assess the risks of material misstatement due to fraud.</p> <p>Risks identified and the auditor's response (both the overall responses and responses at the assertion level).</p> <p>If revenue recognition is not identified as a risk factor, the reasons why.</p> <p>Results of procedures related to management override of controls.</p> <p>Other conditions or analytical procedures that led the auditor to perform additional auditing procedures.</p> <p>Fraud-related communications to management, the audit committee, and others.</p> |
| AU-C 250, <i>Consideration of Laws and Regulations in an Audit of Financial Statements</i> (paragraph .28)                                     | Description of the identified or suspected noncompliance with laws and regulations and the results of discussion with management, and those charged with governance.   |
| AU-C 260, <i>The Auditor's Communication with Those Charged with Governance</i> (paragraph .20)  | Required communications to those charged with governance about matters involving the auditor's responsibilities, the planned scope and timing of the audit, and significant audit findings.  |
| AU-C 265, <i>Communicating Internal Control Related Matters Identified in an Audit</i> (paragraphs .11-.16)                                    | Communication of significant deficiencies and material weaknesses in internal control made to management and those charged with governance.  |
| AU-C 300, <i>Planning an Audit</i> (paragraph .14)   | Document the overall audit strategy, the audit plan, and any significant changes made during the audit engagement to the overall audit strategy or to the audit plan.  |

| Reference  | Nature of Documentation  |
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| AU-C 315, <i>Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement</i> (paragraph .33)             | <p>Audit team discussion of the susceptibility of the client's financial statements to error or fraud (when the discussion occurred, who participated, subjects discussed, and planned audit responses).</p> <p>The auditor's understanding of the entity's environment and its internal control (including sources of information and risk assessment procedures).</p> <p>The auditor's assessment of the risk of material misstatement at the financial statement level and the assertion level and the auditor's basis for these assessments.</p> <p>Risks identified and evaluation of related controls.</p> <p>Materiality for financial statements as a whole.</p> |
| AU-C 320, <i>Audit Risk and Materiality in Conducting an Audit</i> (paragraph .14)   | <p>Materiality level(s) for particular classes of transactions, account balances, or disclosures.</p> <p>Performance materiality.</p> <p>Overall audit response to the assessed risk of misstatement at the financial statement level.</p>   |
| AU-C 330, <i>Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained</i> (paragraphs .30-.33) | <p>Nature, timing, and extent of further audit procedures performed.</p> <p>Linkage of procedures to risks at the assertion level.</p> <p>Results of audit procedures.</p> <p>Decision regarding the operating effectiveness of controls obtained in a prior audit and their use in the current audit.</p> <p>Determination not to use external confirmation procedures for accounts receivable when the account balance is material.</p> <p>Demonstrate that the financial statements agree or reconcile with the underlying accounting records.</p> <p>Amount below which misstatements would be regarded as clearly trivial.</p>                                      |
| AU-C 450, <i>Evaluation of Misstatements Identified during the Audit</i> (paragraph .12)   | <p>All misstatements accumulated during the audit and whether they have been corrected.</p> <p>The auditor's conclusion about whether uncorrected misstatements are material, individually or in the aggregate, and the basis for that conclusion.</p>   |
| AU-C 501, <i>Audit Evidence—Specific Considerations for Selected Items</i> (paragraph .20)   | Basis for determination to not seek direct communication with the entity's legal counsel.  |

## Analysis and Application of Procedures

### *Sufficient Appropriate Audit Evidence*

Audit evidence is cumulative in nature, and includes evidence from (1) procedures performed during the audit, (2) results from prior-year audits, and (3) the firm's quality control process for client acceptance and continuance. Audit evidence includes both information that supports and information that contradicts management's assertions and in some cases may include the absence of information, such as when management refuses to provide a requested representation. Many types of audit procedures are performed to obtain audit evidence. Inquiry is one of these audit procedures that may provide important audit evidence, but that alone is not sufficient to test the operating effectiveness of controls and generally does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level.

The auditor obtains reasonable assurance regarding his or her audit conclusions when sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level. The sufficiency and appropriateness of audit evidence are interrelated and, as the relevance and reliability of evidence increases, the quantity of evidence required may decrease. However, increased quantities of audit evidence may not compensate for poor-quality evidence. The reliability of audit evidence depends on its source, its nature, and the circumstances under which it is obtained. Audit judgment is used to determine when the audit evidence obtained is sufficient and appropriate to draw reasonable conclusions on which to base the audit opinion.

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**PUBLIC COMPANY IMPLICATION:** The PCAOB's AS-1105 (*Audit Evidence*) defines what constitutes audit evidence, and it provides guidance to the auditor of a public company in evaluating the sufficiency and appropriateness of audit evidence. Although there are a number of differences between the PCAOB's and ASB's risk standards, the risk-assessment concepts contained in the PCAOB standards should be familiar to most auditors. Audit risk is the risk that the auditor will issue an inappropriate opinion on financial statements that are materially misstated. The auditor is to reduce audit risk to a low level through the application of audit procedures. The guidance in AU-C 500 is largely consistent with AS-1105.

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**FRAUD POINTER:** A very common deficiency in enforcement actions against auditors is the auditor's failure to gather adequate audit evidence. In some cases, the SEC has highlighted specific areas where evidence was inadequate, such as auditors' examinations of draft contracts rather than final contracts and auditors' failure to obtain evidence related to all the steps in written audit programs. In these instances, the SEC believed the failure to gather adequate evidence prevented the auditors from detecting material misstatement due to fraud.

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Audit evidence is obtained from a variety of sources. Some audit evidence is obtained from audit procedures testing the accounting records to determine that the records are internally consistent and agree to the financial statements. Accounting records alone, however, do not provide sufficient appropriate audit evidence for the auditor's opinion. Additional assurance is typically obtained from consistent or corroborating audit evidence from other sources, such as those independent of the entity. Sources of information independent of the entity that the auditor may use as audit evidence may include third-party confirmations, analysts' reports, and benchmarking data about competitors.

### *Audit Procedures*

The auditor obtains audit evidence by performing three types of procedures: (1) risk assessment procedures, (2) tests of controls, and (3) substantive procedures, which include tests of details and substantive analytical procedures. Tests of controls should be performed when required by auditing standards or when the auditor chooses to perform these tests.

Audit evidence gathering procedures used by the auditor include (1) inspection, (2) observation, (3) external confirmation, (4) recalculation, (5) reperformance, (6) analytical procedures, and (7) inquiry. In some cases, audit evidence gathered in previous years' audits may continue to provide sufficient appropriate audit evidence, but the auditor should perform audit procedures to ascertain the continuing relevance of this evidence from prior years.

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**PLANNING AID REMINDER:** Often the accounting data and corroborating evidence only exist in electronic form, and that evidence may only exist at a certain point in time. As a result, some of that evidence may not be visible in written form and it might not be retrievable after certain points in time. As part of planning the audit, the auditor should identify the time that evidence might exist or is available and consider that timing when planning the audit. In some cases, the auditor might determine that the use of IT specialists is appropriate in performing the audit.

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### *Inspection*

Inspection involves examining documents or records or physically examining an asset. The reliability of the audit evidence obtained from inspecting documents or records varies depending on the nature and source of the documents and records, and on the strength of internal control for internally generated documents and records. Inspection of tangible assets can provide useful audit evidence regarding the existence of the asset. It is a less effective procedure for providing evidence related to valuation of an asset and the entity's right to use it. Inspection is sometimes paired with observation as an evidence-gathering technique—for example, auditors often inspect individual assets during a physical inventory observation.

*Observation*

Observation involves looking at a client-performed process or procedure (e.g., observation of the entity's process for counting inventory, observation of the performance of a control procedure). Observation is limited to providing evidence about the state of a process or procedure at the time its performance is observed. Also, the very act of observing a process or procedure may change its performance—that is, client personnel may perform a process or procedure differently than normal when they know the auditor is watching.

*External confirmation*

A confirmation is a specific type of inquiry. It involves asking a third party to make a representation through a direct written response to the auditor about certain information or of an existing condition (e.g., confirmation of an accounts receivable balance). Often confirmations are used to provide audit evidence related to account balances, but they can also be used to confirm the existence of any agreements that may affect an account balance (e.g., a side agreement allowing a customer to return goods if the customer is not able to resell them).

*Recalculation*

Recalculation is a procedure that involves checking the mathematical accuracy of documents or records.

*Reperformance*

The auditor may reperform a procedure or control that is part of the entity's internal control. For example, an entity may have a control that involves the assistant controller reviewing the account coding for cash disbursements. The auditor could reperform this procedure.

*Analytical procedures*

Analytical procedures involve analyzing the reasonableness of financial information by comparing it with other financial and nonfinancial data. For example, the auditor might evaluate the reasonableness of the allowance for doubtful accounts by relating the allowance to the ratio of days' sales in receivables. In performing analytical procedures, the auditor should develop his or her own independent expectation of the account balance (or ratio etc.) *before* performing the analytical procedure. The effectiveness of an analytical procedure largely depends on the auditor's subsequent investigation of fluctuations or relationships that are inconsistent with other data or that deviate significantly from the auditor's expectations.

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**FRAUD POINTER:** In some cases, the auditor uses the prior year's audited balance as the implicit expectation and then focuses on differences between the recorded amount and the prior year's balance in performing the analytical procedure. In some cases, the *lack of a difference* between the recorded amount and the prior year's balance is just as problematic as the existence of a difference.

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Scanning is a type of an analytical procedure. Scanning involves reviewing accounting records (e.g., transaction listings, subsidiary ledgers, general ledger control accounts, adjusting entries, suspense accounts, reconciliations) for large or unusual items and then testing them. The effectiveness of scanning depends on the auditor's ability to define unusual items. Scanning is implemented most effectively through the use of electronic auditing procedures.

*Inquiry*

Inquiry involves asking questions to obtain information from knowledgeable sources. The auditor should consider making inquiries of both financial and nonfinancial personnel and of personnel both inside and external to the entity. Inquiry involves both formal written inquiries and informal oral questions. Inquiry is typically a complementary procedure to another audit evidence-gathering technique, and its effectiveness depends on the auditor's ability to evaluate the responses received.

Responses to inquiries may provide the auditor with new information, corroborative audit evidence, or contradictory audit evidence. The auditor may choose to modify or perform additional audit procedures based on his or her evaluation of these inquiry responses.

Inquiry may be used in assessing management intent where such intent is determinative of the accounting under U.S. GAAP (e.g., the classification of securities held as investments). Management may state that it has the positive intent and ability to hold a debt security to maturity, but finding evidence to corroborate this management representation may be difficult. In such cases, management's past history of doing what it says may provide evidence either to support or refute its representations.

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**FRAUD POINTER:** Inquiry of senior management is likely to be particularly ineffective in cases of fraud where top management is involved. Note also that AU-C 240 (*Consideration of Fraud in a Financial Statement Audit*) requires the auditor to make certain inquiries related to the risk of fraud.

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**ENGAGEMENT STRATEGY:** Some responses to inquiries are of sufficient importance that the auditor may wish to obtain written representations from management or those charged with governance.

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*Relevance and Reliability*

The relevance and reliability of information impacts the quality of the audit evidence.

*Relevance*

Relevant audit evidence relates to the specific assertion being tested by the auditor. For example, observation of the client's physical inventory count provides relevant audit evidence related to the existence assertion for the inventory

account balance. The direction of testing is a factor that affects the relevance of audit evidence.

The audit procedures used also affect the relevance of audit evidence. Certain audit procedures may provide audit evidence relevant to particular assertions but not others. The auditor should bear in mind that audit evidence provided about one assertion is not a substitute for audit evidence about another assertion. It is also important to remember that audit evidence from different procedures or sources may be relevant to the same assertion.

### Reliability

The reliability of audit evidence is determined by referring to its source, its nature, and the circumstances under which it is obtained. Although there are exceptions to these general principles, audit evidence is more reliable when it:

- Is obtained from a knowledgeable, independent source external to the entity.
- Is produced by a system with effective internal control.
- Is obtained directly by the auditor (e.g., observation, reperformance) rather than indirectly (e.g., inquiry).
- Exists in documentary form.
- Exists in original form (rather than as a copy, fax, or document that has been transformed into electronic form).

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**FRAUD POINTER:** Although the auditor is expected to evaluate the reliability of audit evidence, he or she is not expected to authenticate the validity of written documents. The auditor is not trained in authenticating documents and auditing standards do not expect auditors to have this expertise. Nonetheless, many frauds are perpetrated through the creation of bogus documentation or the alteration of legitimate documentation. The auditor should be cognizant of this risk, and may want to involve forensic specialists in high risk engagements, particularly where questions about the authenticity of documentation arise.

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### Entity-Produced Information

The auditor often uses information produced by the entity as the source for other audit procedures. When the auditor uses client-generated information, he or she needs to test whether the information is accurate and complete. The auditor may test the completeness and accuracy of client-generated information at the same time that he or she is performing another audit procedure using that data. Rather than directly testing the accuracy and completeness of client-generated information, the auditor may, alternatively, test the controls over the production and maintenance of the information.

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**PLANNING AID REMINDER:** Due to concerns about IRS access to tax accrual papers, a client may fail to adequately document its income tax accrual or may deny the auditor access to this information. In accordance with Interpretation 1 of AU 500, limitations on access to information needed to audit the tax accrual will

necessitate the auditor issuing either a qualified opinion or a disclaimer of opinion. Moreover, client requests for the auditor not to retain documentation of the client's support for its income tax accrual, or the auditor's evaluation thereof, cannot be honored if this request would preclude the auditor from adequately documenting the audit procedures performed, findings obtained, and conclusions reached. Finally, the auditor cannot rely on an opinion from in-house legal counsel, outside counsel, or third-party tax advisers as to the adequacy of the client's income tax accrual in lieu of the auditor's own procedures.

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The entity may use a management's specialist to provide expertise in an area other than accounting or auditing that is used to assist in preparing its financial statements. In these situations, the auditor performs audit procedures to evaluate the specialist's work and the nature, timing, and extent of the audit procedures performed may depend on several factors such as:

- The nature and complexity of the matter of the specialist's work.
- The risks of material misstatement in the matter.
- The availability of alternative sources of audit evidence.
- The nature, scope, and objectives of the specialist's work.
- Whether the specialist is employed or engaged by the entity.
- The extent of management's control or influence over the specialist's work.
- Whether the specialist is subject to technical performance standards or other professional or industry requirements.
- The nature and extent of entity controls over the specialist's work.
- The auditor's knowledge of and experience with the specialist's field of expertise.
- The auditor's previous experience with the specialist's work.

Information about the competence, capabilities, and objectivity of a management's specialist may come from sources such as personal experience with prior work of the specialist, discussions with the specialist, with an auditor's specialist, or with others familiar with the specialist's work, knowledge of the specialist's qualifications, or works published by the specialist. In evaluating the specialist's competence, capabilities, and objectivity, the auditor may consider:

- If the specialist's work is subject to technical performance standards or other professional or industry requirements.
- The relevance of the specialist's competence to the matter for which their work will be used.
- The specialist's competence related to relevant accounting requirements.
- Whether unexpected events, changes in conditions, or audit evidence obtained from results of audit procedures indicate the auditor's initial evaluation of the specialist's competence, capabilities, and objectivity needs to be reconsidered.

If the objectivity of a management's specialist is threatened, safeguards created by external structures or the specialist's work environment may reduce

those threats; however, threats to a management's specialist's objectivity cannot be entirely eliminated. To evaluate the specialist's objectivity, the auditor may inquire of the entity and specialist about any interests or relationships between the entity and specialist that may affect objectivity such as financial interests, business and personal relationships, or the provision of other services. The auditor may also discuss any applicable safeguards and professional requirements applying to the specialist to evaluate whether those safeguards are adequate.

The auditor may find the following relevant in obtaining an understanding of the management's specialist's field of expertise:

- Whether the specialist's field has specialized areas that are relevant to the audit;
- Whether any professional standards or legal or regulatory requirements apply;
- The assumptions, methods, and applicable models used by the specialist and whether they are generally accepted in the specialist's field and appropriate for financial reporting purposes; and
- The nature of internal and external data or information used by the specialist.

If a management's specialist is engaged by the entity, there will likely be a written agreement or engagement letter between the specialist and the entity and evaluation of this agreement may assist the auditor in determining the appropriateness of the nature, scope, and objectives of the specialist's work; the roles and responsibilities of management and the specialist; and the nature, timing, and extent of communication between management and the specialist. If a management's specialist is employed by the entity, it is less likely that there will be such a written agreement and inquiry of management and the specialist may be the best way for the auditor to obtain an understanding of the specialist's work.

When evaluating the appropriateness of a management's specialist's work as audit evidence for the relevant assertion, the auditor may consider:

- The relevance and reasonableness of the specialist's findings or conclusions, their consistency with other audit evidence, and whether they have been appropriately reflected in the financial statements.
- The relevance and reasonableness of any significant assumptions and methods used.
- The relevance, completeness, and accuracy of any significant source data used.

#### *Evidence That Is Inconsistent or of Doubtful Reliability*

If the auditor identified information during an audit that is inconsistent with the final conclusion regarding a significant matter, AU-C 230 addresses specific documentation requirements for the auditor.

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**PLANNING AID REMINDER:** A governmental entity may participate in a governmental cost-sharing multiple-employer pension plan. For example, employees of a city, county, or other municipality may participate in a pension plan offered by the state. The local governmental entity is required to report certain pension amounts in its own financial statements. Some of these amounts are calculated by the plan (e.g., the state pension plan) or the plan's actuary, and the underlying records may be maintained only by the plan. In accordance with Interpretation 2 of AU 500, the audited financial statements of the plan and additional unaudited information provided by the plan do not constitute sufficient appropriate audit evidence for the audit of the local governmental entity's own financial statements. Additional audit procedures need to be performed on the schedule of employer allocations, and certain key elements in a schedule of pension amounts including the net pension liability, total deferred inflows and outflows of resources, and total pension expense in order for the auditor of the local governmental entity to accumulate sufficient appropriate audit evidence. In auditing the local governmental entity's pension amounts, the audit report issued by the auditor of the plan can be considered as evidence by the local governmental entity's auditor. However, the local auditor should consider whether the plan's auditor's report and the accompanying schedules are adequate and appropriate, and whether the plan auditor has the necessary competence and independence. Interpretation 3 of AU-C 500 provides essentially the same guidance for governmental entities that participate in a governmental agent multiple-employer pension plan.

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## SECTION 501

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**AUDIT EVIDENCE—SPECIFIC CONSIDERATIONS FOR  
SELECTED ITEMS**


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**Authoritative Pronouncements**

SAS-122—Statements on Auditing Standards: Clarification and Recodification

**Overview**

AU-C 501 provides guidance for the auditor in obtaining sufficient appropriate audit evidence in accordance with relevant AU-Cs regarding the:

- Valuation of investments in securities and derivative instruments;
- Existence and condition of inventory;
- Completeness of litigation, claims, and assessments involving the entity; and
- Presentation and disclosure of segment information in accordance with the applicable financial reporting framework.

**Requirements**

The auditor is presumptively required to perform the following procedures in obtaining sufficient appropriate audit evidence for the following selected items:

***Investments in Securities Valued Based on Investee's Financial Results  
Excluding Investments Accounted for Using Equity Method of Accounting***

1. When investments in securities are valued based on an investee's financial results (excluding investments accounted for using the equity method of accounting), obtain sufficient appropriate audit evidence supporting the investee's financial results by:
  - a. Obtaining and reading the available financial statements of the investee and any accompanying audit report and determining if the audit report is satisfactory for this purpose.
  - b. If the investee's financial statements are not audited or the audit report is not satisfactory, apply (or request the investor arrange with the investee to have another auditor apply) appropriate auditing procedures to the financial statements, considering the materiality of the investment to the investor entity's financial statements.
  - c. Obtaining sufficient appropriate audit evidence if the carrying amount of the investment reflects factors not recognized in the investee's financial statements or fair values of assets that are materially different from the investee's carrying amounts.
  - d. If there is a time lag between the date of the entity's and the investee's financial statements that could have a material effect on the entity's financial statements, determine if the entity's management has considered the lack of comparability and determine any effect this has on the auditor's report.

If sufficient appropriate audit evidence cannot be obtained because the auditor is unable to perform one or more of these procedures, determine the effect on the auditor's opinion in accordance with AU-C 705 (*Modifications to the Opinion in the Independent Auditor's Report*).

2. To address subsequent events and transactions of the investee occurring after the date of the investee's financial statements but before the auditor's report date, obtain and read available interim financial statements of the investee and make appropriate inquiries of the investor's management to identify events and transactions that may be material to the investor's financial statements that need to be recognized or disclosed in the financial statements.

***Investments in Derivative Instruments and Securities Measured or Disclosed at  
Fair Value***

3. Determine whether the applicable financial reporting framework specifies the method to be used to determine the fair value of the entity's derivative investments and investments in securities and evaluate whether the determination of fair value is consistent with the specific valuation method.
4. If fair value estimates of derivative instruments or securities are obtained from broker-dealer or other third-party sources based on proprietary valuation models, understand the method used in developing the estimate and consider the applicability of AU-C 500 (*Audit Evidence*).
5. If fair value estimates of derivative instruments or securities are developed by the entity using a valuation model, obtain evidence supporting management's assertions about fair value determined using the model.

***Impairment Losses***

6. When considering impairment losses, evaluate management's conclusion about the need to recognize an impairment loss for a decline in a security's fair value below its cost or carrying amount and obtain sufficient appropriate audit evidence supporting the amount of any impairment adjustment recorded, including evaluating whether the entity complied with the requirements of the applicable financial reporting framework.
7. Obtain sufficient appropriate audit evidence about the amount of unrealized appreciation or depreciation in the fair value of a derivative that is recognized or disclosed because of the ineffectiveness of a hedge, including evaluating whether the entity complied with the requirements of the applicable financial reporting framework.

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**FRAUD POINTER:** Fraudulent financial reporting enforcement actions issued by the SEC often highlight cases that involve asset overstatements. Assets related to fair value measurement and disclosure might involve heightened fraud risk because of the significant opportunities for management to perpetrate fraud related to those accounts. The significant dependence on management assumptions and the related complexities associated with measuring and disclosing fair value instruments can create significant opportunities for management to engage in fraud. Conversely, in a private company the risk may be an understatement of assets (i.e., an overstatement of expenses) so as to reduce income taxes.

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When nonstatistical sampling is employed, the auditor may review the population or the prior years' audit documentation to acquire an understanding of the variation within the population. When a classical variable statistical sampling technique is employed, the auditor measures the variation in the population by computing the estimate of the standard deviation of the sample mean.

It may be efficient to stratify a population with a high degree of variation. "Stratification" simply means that the population is divided into groups (strata) of sampling units that have the same or approximately the same dollar values, and samples are selected from each group. Stratification is necessary to reduce the effect of the variation in the population on the size of the sample. (In both nonstatistical sampling and statistical sampling, as the variation increases, the auditor needs to select a larger sample size.)

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**ENGAGEMENT STRATEGY:** When probability proportional to size (PPS) sampling is used, there is no need to consider the variation within the population, because this technique automatically considers that factor since it is a combination of both attribute sampling and variable estimation.

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#### Step 4b—Consider the acceptable level of risk

When considering whether to accept or reject the results of a sample, the auditor is faced with the risks of (1) incorrect rejection of a balance and (2) incorrect acceptance of a balance. The risk of incorrect rejection of a balance is the risk that the results of a sample will lead the auditor to conclude that the recorded account balance is materially misstated when, in fact, the recorded account balance is not materially misstated. The risk of incorrect acceptance of a balance is the risk that the results of a sample will lead the auditor to conclude that the recorded account balance is not materially misstated when, in fact, the recorded account balance is materially misstated.

In determining an acceptable level of risk of incorrect acceptance for tests of details, the auditor should consider (1) the assessed risk of material misstatement (inherent risk and control risk) and (2) the risk that other relevant substantive procedures (including substantive analytical procedures) would not detect a material misstatement. These risk factors and interrelationships must be considered in non-statistical sampling plans as well as in statistical sampling plans. These relationships are in the following manner:

$$TD = AR / (IR \times CR \times AP)$$

where:

- AR = the allowable audit risk that monetary misstatements equal to tolerable misstatement might remain undetected for the account balance or class of transactions and related assertions after the auditor has completed all audit procedures deemed necessary.
- IR = the susceptibility of an assertion to a material misstatement assuming there are no related internal controls.

- CR = the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the entity's internal controls. (The auditor assesses control risk on the basis of the sufficiency of audit evidence obtained to support the effectiveness of internal controls.)
- AP = the risk that analytical procedures and other relevant substantive procedures would fail to detect misstatements that could occur in an assertion equal to tolerable misstatement, given that such misstatements occur and are not detected by the internal control.
- TD = the allowable risk of incorrect acceptance for the test of details, given that misstatements equal to tolerable misstatement occur in an assertion and are not detected by internal control or analytical procedures and other relevant substantive procedures.

The above equation emphasizes relationships among the various factors that the auditor must consider when determining the allowable risk of incorrect acceptance. For example, as control risk rises, the allowable risk of incorrect acceptance must decrease to achieve a stated level of audit risk. That relationship is based on the simple logic that as the perceived effectiveness of internal control decreases, the auditor is less willing to establish a high allowable risk of incorrect acceptance of an account balance. Stated in terms of its effect on sample size, it is necessary to increase the size of the sample as control risk increases to reduce the level of risk of incorrect acceptance. Thus, from the perspective of sample size and all other factors remaining constant, there is an inverse relationship between control risk and the allowable risk of incorrect acceptance.

Although the relationships established in the above equation are intuitive, it is unlikely that an auditor would assign an absolute value to audit risk; rather he or she would evaluate the risk in an abstract manner. Even when statistical sampling is employed, most auditors would use the relationships established by the equation as a guide, avoiding a strict and comprehensive quantitative approach arrived at by simply plugging in risk factors. Even if an auditor insists on a strictly quantitative approach, that does not imply that judgment has been removed from the process. In a strictly quantitative approach, the process may appear to be unbiased but, as discussed in this section, the risk factors are based on a number of decisions that depend heavily on professional judgments. Those judgments are the same for non-statistical sampling and statistical sampling.

#### Step 4c—Consider the tolerable misstatement

The tolerable misstatement is an estimate of the maximum monetary misstatement that may exist in an account balance or group of transactions when combined with misstatement in other accounts, without causing the financial statements to be materially misstated. The tolerable misstatement is based on the auditor's definition of "materiality," or the maximum amount by which the financial statements could be misstated and still be in accordance with generally accepted accounting principles. There is an inverse relationship between the tolerable misstatement and the required sample size. Thus, the sample size must be increased when the tolerable misstatement is decreased.

Tolerable misstatement is related to the auditor's planned level of materiality for the financial statements as a whole such that tolerable misstatement when combined for all planned audit procedures does not exceed materiality for the financial statements. Thus, auditors should set tolerable misstatement for a specific audit procedure at an amount less than the financial statements so that when the results are aggregated, the required level of overall assurance is obtained.

#### *Step 4d—Consider the expected amount of misstatement*

An estimate of the expected amount of misstatement in a particular account balance or group of transactions is based on the following factors:

- Understanding of the entity's business,
- Prior years' tests of the population,
- Results of a pre-audit sample, and
- Results of tests of controls.

The required sample size increases as the auditor's estimate of the expected amount of misstatement in the population increases.

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**PLANNING AID REMINDER:** In practice it is often difficult to determine the expected amount of misstatement, but this can be overcome by combining the effects of the tolerable misstatement and the expected amount of misstatement. This can be accomplished by establishing a materiality threshold and then dividing that amount by "about 2" in order to establish the tolerable misstatement. For example, if materiality is established at \$100,000, then the tolerable misstatement would be about \$50,000 ( $\$100,000/2$ ). Then only the (adjusted) tolerable misstatement would be used to determine the required sample size.

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#### *Step 4e—Consider the population size*

The population size generally has an effect on the sample size, depending on which sampling technique the auditor employs.

#### *Step 5—Determine the method of selecting the sample*

The auditor must select sampling units from the defined population in such a way that each sampling unit has a chance of being selected. The auditor's objective is to select a representative sample of all items from the population. If statistical sampling is used, the sample selection must be random.

#### *Step 6—Perform the sampling plan*

Once the sample has been selected, the auditor should apply appropriate audit procedures. If the auditor is unable to perform an audit procedure on a sampling unit selected for examination, alternative audit procedures should be considered. If the sampling unit does not have an effect on the conclusion the auditor reaches concerning the acceptability of the population, alternative audit procedures do not have to be applied, and the sampling unit may be treated as a misstatement for evaluation purposes. In addition, the auditor should determine whether the

inability to apply an audit procedure has an effect on the assessed level of control risk or the assessment of risk on representations made by the client.

#### *Step 7—Evaluate the sample results*

After testing the sample units, the auditor should evaluate the sample results to determine whether the account balance or group of transactions is correct and in accordance with generally accepted accounting principles.

#### *Step 7a—Project the misstatement to the population and consider sampling risk*

The misstatements discovered in the sampling units should be projected to the total population. In its simplest form, a \$2,000 misstatement in a sample that represents 20% of the population would be projected as a total misstatement of \$10,000 ( $\$2,000/20\%$ ). The method of projecting the misstatement to the total population will depend on the type of sampling technique the auditor uses.

If the projected misstatement is greater than the tolerable misstatement, the account balance cannot be accepted as correct. If the projected misstatement is significantly less than the tolerable misstatement, the auditor may conclude that the account balance is not materially misstated. For example, if the projected misstatement is \$10,000 and the tolerable misstatement is \$50,000, in most instances the risk of accepting an incorrect balance would be acceptable. As the projected misstatement approaches the tolerable misstatement, the risk of accepting an incorrect balance increases, and the auditor must use professional judgment in deciding whether to accept a balance as correct. For example, if the projected misstatement is \$40,000 and the tolerable misstatement is \$50,000, in most instances the risk of accepting an incorrect balance would not be acceptable.

#### *Step 7b—Consider the qualitative aspects of misstatements and reach an overall conclusion*

Each misstatement the auditor discovers by testing the sample should be evaluated to determine why the misstatement was made and whether the misstatement has an effect on other phases of the engagement. For example, the discovery of a fraudulent act would have broader implication to the auditor than the discovery of a routine error.

The results of the substantive procedures may suggest that the assessed level of control risk was too low. Such a condition would require the auditor to consider whether substantive procedures should be expanded.

#### *Step 8—Document the sampling procedures*

The auditor should consider the following matters for documentation in the audit files:

- Description of audit procedures and objectives tested;
- Definition of population and sampling unit;
- Definition of a misstatement;
- Basis for establishment of risk of incorrect acceptance, incorrect rejection, tolerable misstatement, and expected misstatement;

- Audit sampling technique used;
- Method of sampling selection;
- Description of sampling procedures performed and list of misstatements discovered [deviations should be classified as unintentional and (suspected) intentional acts]; and
- Evaluation of sample and summary of overall conclusions.

#### NON-STATISTICAL SAMPLING FOR TESTS OF DETAIL

This section is based on the discussion in the previous section, but it focuses exclusively on non-statistical sampling for tests of detail. The guidance provided here is based on material in Chapter 5 of the AICPA's *Audit Guide Audit Sampling* (a new edition of this Guide was released by the AICPA on May 1, 2008).

#### Promulgated Procedures Checklist

The auditor may use the following steps to apply non-statistical sampling concepts to tests of details:

- Identify individually significant items,
- Determine the sample size,
- Select the sample, and
- Evaluate the sample results.

#### Analysis and Application of Procedures

##### Identify Individually Significant Items

Initially the auditor should review the items that make up the population to determine whether certain items should be tested 100% rather than sampled. The items selected for 100% testing might be based on the dollar value of the item or unusual characteristics of the item. For example, an auditor may review the trial balance of accounts receivable and decide that all receivables that exceed \$1,000 should be selected for confirmation. Generally larger-dollar amounts within a population are selected for 100% testing based on the auditor's judgment.

##### Determine the Sample Size

The size of the sample in non-statistical sampling is based on professional judgment. The auditor cannot simply decide to use a rule of thumb in all engagements and expect to satisfy professional standards or to perform an effective engagement. For example, if the auditor has a rule of thumb that he or she always confirms 10% of the dollar value of accounts receivable, that approach is a violation of generally accepted auditing standards.

The Audit Guide *Audit Sampling* points out that when an auditor uses non-statistical sampling to perform test of details, the following four factors (discussed in the previous section) must be taken into consideration:

1. Population variation,
2. Risk of incorrect acceptance,
3. Tolerable misstatement and expected misstatement, and
4. Population size.

Although these factors sound like concepts that are found in a statistics course, they are actually based on common sense.

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**PLANNING AID REMINDER:** Although the auditor must take the four factors listed above into consideration in determining the size of the sample, he or she does not have to quantify these factors. Also, some auditors believe that there is some simple solution to determining sample size that does not have to take into consideration the four factors listed above. There is no simple rule-of-thumb solution. An auditor must take these factors into consideration and use professional judgment to determine the size of a sample, even when non-statistical sampling is used.

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##### Population variation

In general, the more homogenous the population, the smaller the sample size can be. That is, for example, if the trial balance of accounts receivable is made up of balances that range from \$150 to \$220, there is little variation in the population. For this reason, an auditor can test relatively few items in order to get a representative sample of the accounts receivable. On the other hand, if the range of balances in accounts receivable is from \$5 to \$25,000, this population exhibits more variability and it would be necessary to test a larger number of accounts receivable.

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**ENGAGEMENT STRATEGY:** In practice it is unlikely that an accounting population will have as small degree of variation as suggested in the above paragraph; however, it is possible to divide the population into groupings (population stratification) and thus significantly reduce the degree of variation in each grouping. Also, it should be remembered that a group of the population may be tested 100% and evaluated separately. Stratification and testing some of the items 100% will almost always reduce the overall size of the sample.

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The auditor can get a feel for the variation within a population by reviewing the items that make up the population. For example, a simple review of the trial balance of accounts receivable should give the auditor a reasonable impression of the variability of the population. A more precise measurement of variability can be determined quickly if the trial balance is digitized and can be subjected to analysis by various file analyzers. For example, if the trial balance of accounts receivable is maintained in a spreadsheet file, such as an Excel spreadsheet, it might be possible to create statistics such as the variance or standard deviation of the population.

##### Risk of incorrect acceptance

As discussed earlier in this section, an interplay exists among audit risk, inherent risk, and control risk. These relationships can be summarized as follows:

- When the combined inherent and control risks are assessed at a lower level, a greater risk of incorrect acceptance for planned substantive procedures can be established. Under this circumstance, the required sample size is decreased.
- When the combined inherent and control risks are assessed at a higher level, a lower risk of incorrect acceptance for planned substantive procedures can be established. Under this circumstance, the required sample size is increased.
- When the auditor relies more heavily on other substantive procedures (including analytical procedures) to achieve the same audit objective, a greater risk of incorrect acceptance for planned substantive procedures can be established. Under this circumstance, the required sample size is decreased.
- When the auditor relies less heavily on other substantive procedures (including analytical procedures) to achieve the same audit objective, a lesser risk of incorrect acceptance for planned substantive procedures can be established. Under this circumstance, the required sample size is increased.

#### *Tolerable misstatement and expected misstatement*

The establishment of a sample size in non-statistical sampling must take into consideration the tolerable misstatement (the size of the error that the auditor considers to be tolerable) and the expected misstatement. In general, as the size of the tolerable misstatement increases, the required sample size decreases. For example, if the auditor believes that a tolerable misstatement in the accounts receivable balance is \$30,000 rather than \$10,000, the number of items that must be in the sample is decreased.

In determining the size of a sample, the auditor should also take into consideration the expected misstatement in the population. As the expected misstatement in the population increases, the required sample size must be increased. That is, if an auditor does not have much faith in the balances under investigation, common sense would require an auditor to test more items from the population.

#### *Population size*

The size of the population has little effect on the size of the sample. Thus, if one trial balance of accounts receivable has 2,000 line items and another trial balance has 4,000 line items, assuming all other factors are equal, both populations would require essentially the same sample size.

**ENGAGEMENT STRATEGY:** It is easy for auditors to overemphasize the size of the population in determining the required sample size for a particular balance. For example, if the auditor has a rule of thumb that he or she samples 10% of the items of the population, the result is a misapplication of auditing standards. In the previous example, the auditor would select 200 items from the first population and 400 items from the second, but that doubling of the sample size in the second population is not supported by sampling concepts. It is far more impor-

tant for the auditor to thoughtfully look at the other three factors discussed above, rather than population size, in determining the required sample size for a population.

**Consider the interplay of the four factors** The auditor uses professional judgment to evaluate the four factors described above and, based on this evaluation, determines the required sample size. There is no single approach that an auditor should use to make this determination; however, for illustrative purpose the AICPA *Audit Sampling* Guide describes the following as an approach that an auditor may consider:

- Consider the level of inherent risk.
- Consider the effectiveness of controls related to the financial statement assertions.
- Establish the risk of incorrect acceptance.
- Establish a tolerable misstatement level.
- Evaluate the effect of other related tests of details.
- Determine the population reported amount.
- Compute the preliminary sample size.
- Adjust the preliminary sample size.

**ENGAGEMENT STRATEGY:** The AICPA Audit Guide *Audit Sampling* is careful not to endorse any particular method for determining sample size but describes the usefulness of the approach described above as follows: The model is provided only to illustrate the relative effect of different planning considerations on sample size; it is not intended as a substitute for professional judgment. The auditor can find this approach useful to get a feel for how various assessments of the four factors described earlier can have on the required sample size.

**Consider the level of inherent risk** Initially the auditor assesses the level of inherent risk related to the particular assertions in the financial statements that will be tested once the sample is selected. Inherent risk is the susceptibility of an assertion to a material misstatement, assuming that there are no related controls. AU-C 500 (*Audit Evidence*) attempts to provide the logical framework for the audit process by identifying the following broad assertions that must be tested:

- Assertions for classes of transactions.
- Assertions for account balances.
- Assertions for presentation and disclosure.

**Consider the effectiveness of controls related to the financial statement assertions** Once the specific financial statement assertions are identified, the auditor should consider the effectiveness of the controls related to the prevention and detection of material misstatements related to the assertions. Control risk is the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the entity's internal control.

maintains responsibility for the establishment of the overall audit strategy. The requirements in AU-C 610 relating to direct assistance do not apply if the external auditor does not plan to use internal auditors to provide direct assistance.

The external auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the external auditor's use of the work of the internal audit function or the use of internal auditors to provide direct assistance on the engagement. This section provides guidance to assist the auditor in using that work.

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**PUBLIC COMPANY IMPLICATION:** In 2003, the New York Stock Exchange (NYSE) changed its listing requirements to mandate that all NYSE registrants have an internal audit function. NASDAQ has considered a similar requirement, but withdrew its proposal for further consideration.

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### Definitions

|                         |   |
|-------------------------|---|
| Direct assistance       | The use of internal auditors to perform audit procedures under the direction, supervision, and review of the external auditor.  |
| Internal audit function | A function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management, and internal control processes. |

### Requirements

To determine if the work of the internal audit function can be used in the audit of the financial statements, the auditor must perform the following procedures:

#### Evaluating the Internal Audit Function

- As part of the determination of whether internal audit's work can be used as part of the auditor's audit evidence-gathering procedures, the external auditor evaluates:
  - Whether the extent of internal audit's organizational status and relevant policies and procedures support the objectivity of internal auditors,
  - Internal audit's level of competence, and
  - Whether internal audit applies a systematic and disciplined approach to its work, including quality control.
- There may be circumstances that warrant not using the work of internal audit. The external auditor should not use the work of internal audit if:
  - The organizational status of internal audit and its relevant policies and procedures do not support internal audit's objectivity,
  - The competence of internal audit is not sufficient, or
  - Internal audit does not apply a systematic and disciplined approach to its work, including quality control.

#### Using the Work of Internal Audit: Determining Nature and Extent of Work of Internal Audit

- To determine the nature and extent of the work of internal audit that can be used in obtaining audit evidence, the external auditor should consider the nature, timing, and extent of the work internal audit has performed or plans to perform. Part of that consideration is an assessment of the relevance of that work to the external auditor's overall audit strategy and audit plan.
- Even though the external auditor may use the work of internal audit, the external auditor should make all significant judgments in the audit engagement, even when the work of internal audit may be relevant to those judgments.
- A number of factors may impact the extent of the external auditor's use of the work of internal audit. The external auditor should perform more work directly and use less of the work by internal auditor when:
  - More judgment is involved in planning and performing relevant audit procedures or evaluating the audit evidence obtained.
  - The organizational status of internal audit or its policies and procedures are less likely to support the objectivity of internal auditors.
  - The assessed risk of material misstatement at the assertion level is higher, especially when those risks involve significant risks.
  - Internal auditor's competence is less.
- If the auditor also plans to use internal auditors to provide direct assistance, the external auditor should evaluate in the aggregate the use of the work of internal audit in obtaining audit evidence along with the use of internal audit in direct assistance to ensure the external auditor is sufficiently involved in the audit, given the auditor's responsibility to issue the audit opinion.

#### Communicating with Those Charged with Governance

- The external auditor is required by AU-C 260 (*The Auditor's Communication with Those Charged with Governance*) to communicate to those charged with governance matters related to an overview of the scope and timing of the audit. When making those communications, the auditor should describe how the external auditor has planned to use the work of internal audit in obtaining audit evidence.

#### Using the Work of Internal Audit to Obtain Audit Evidence

- The external auditor should coordinate with the internal audit function when the external auditor plans to use the work of internal audit in obtaining audit evidence.
- To obtain an understanding of the nature and extent of audit procedures performed by internal audit, the external auditor should read the reports of the internal audit function that relate to the work where the external auditor plans to use the work of internal audit.
- When the external auditor plans to use the work of internal audit to obtain audit evidence, the external auditor should perform sufficient audit procedures related to the work of internal audit in order to evaluate:
  - If the work of internal audit was properly planned, performed, supervised, reviewed, and documented.
  - If sufficient appropriate audit evidence was obtained to enable internal audit to reach reasonable conclusions.

- c. If the conclusions reached are appropriate in the circumstances, and whether internal audit's reports are consistent with the results of the work performed.
11. A number of factors will help determine the nature and extent of the external auditor's procedures. For example, the following factors may impact the external auditor's evaluation:
- a. The amount of judgment involved in planning and performing relevant audit procedures and evaluating audit evidence obtained,
  - b. The assessed risk of material misstatement,
  - c. The level of competency of internal audit, and
  - d. The organizational status of internal audit, including its policies and procedures.
12. The external auditor should reperform some of the work of internal audit.
13. Before finalizing the audit, the external auditor should evaluate whether information obtained during the audit affects his or her conclusions about internal audit's competence, organizational status, and its application of a systematic and disciplined approach to its work. The external auditor should also evaluate whether the nature and extent of the use of internal audit's work remains appropriate.

#### Using the Work of Internal Audit to Provide Direct Assistance

14. The external auditor may determine that it may be effective and efficient to use internal audit to provide direct assistance on the audit. To do so, the external auditor should evaluate the existence and significance of threats to the objectivity of internal auditors who will be providing the direct assistance, including any safeguards to reduce or eliminate the threats. The external auditor should also evaluate the competency of the internal auditors who will be performing the direct assistance.
15. The use of internal audit to provide direct assistance should not occur if:
- a. Internal audit lacks the competence needed to perform the proposed work.
  - b. Internal audit is lacking the objectivity necessary to perform the proposed work.
16. In determining whether to use internal audit to provide direct assistance, the following factors that impact the external auditor's evaluation should be considered:
- a. The amount of judgment involved in planning and performing relevant audit procedures and evaluating audit evidence obtained,
  - b. The assessed risk of material misstatement, and
  - c. The external auditor's evaluation of the level of competency of internal audit, the existence of threats to the internal auditor's objectivity, including the effectiveness of safeguards to reduce or eliminate the threats.

#### Communicating with Those Charged with Governance

17. Similar to when the external auditor plans to use the work of internal audit to obtain audit evidence, the external auditor should communicate to those charged with governance how the external auditor plans to use the work of internal auditors to provide direct assistance. AU-C 260 (*The Auditor's Communication with Those Charged with Governance*) addresses communicating to those charged with governance matters related to an overview of the scope and timing of the audit.

#### Using the Work of Internal Audit to Provide Direct Assistance

18. Because the external auditor has sole responsibility for the audit opinion expressed, he or she should evaluate whether, in the aggregate, using internal auditors to provide direct assistance or to obtain audit evidence would still result in the external auditor still being sufficiently involved in the audit.
19. Before using internal audit to provide direct assistance, the external auditor should obtain written acknowledgment from management or those charged with governance that internal auditors providing direct assistance will be allowed to follow the instructions of the external auditor and that the entity will not intervene in the work of internal audit performed for the external auditor.
20. The work of internal audit should be directed, supervised, and reviewed by the external auditor. That oversight should take into account the following:
- a. The nature, timing, and extent of direction, supervision, and review should be responsive to the outcome of the evaluation factors in paragraph 16, above,
  - b. The external auditor should instruct the internal auditors to bring accounting and auditing issues identified during the audit to the attention of the external auditor, and
  - c. The external auditor should test some of the work performed by internal audit as part of the external auditor's review.
21. Before finalizing the audit, the external auditor should evaluate whether information obtained during the audit affects his or her conclusions about internal audit's competence, organizational status, and its application of a systematic and disciplined approach to its work. The external auditor should also evaluate whether the nature and extent of the use of internal audit's work remains appropriate.

#### Documentation

22. If the external auditor uses the work of internal audit to obtain audit evidence, the external auditor should include the following in the audit documentation:
- a. Results of the evaluation of internal audit's competence, organizational status, and whether it applies a systematic and disciplined approach, including quality control.
  - b. The nature and extent of the work used (this would also include the period covered by, and the results of, such work) and the basis for the external auditor's decision to use such work.
  - c. Audit procedures performed by the external auditor to evaluate the adequacy of the work used, including the procedures performed by the external auditor to reperform some of the body of work of the internal audit function in obtaining audit evidence.
23. If the external auditor uses the work of internal audit to provide direct assistance, the external auditor should include the following in the audit documentation:
- a. Evaluation of the existence and significance of threats to the objectivity of the internal auditors, as well as any safeguards applied to reduce or eliminate the threats, and the level of competence of the internal auditors to provide the direct assistance.

- b. The basis for the decision regarding the nature and extent of the work performed by internal auditors.
- c. The external auditor's review of the internal auditor's work (this would include the testing by the external auditor of some of the work performed by internal auditors).
- d. Working papers prepared by the internal auditors who provided direct assistance on the audit.

24. Because the external auditor has sole responsibility for the audit opinion expressed, he or she should include in the audit documentation his or her evaluation of whether, in the aggregate, using internal auditors to provide direct assistance or to obtain audit evidence still results in the external auditor still being sufficiently involved in the audit.

### Analysis and Application of Procedures

SAS-128 defines

- The conditions necessary to enable the external auditor to be able to use the work of internal auditors, and
- The necessary work effort to obtain sufficient appropriate evidence that the work of the internal audit function or internal auditors providing direct assistance is adequate for the purposes of the audit.

The requirements are designed to provide a framework for the external auditor's judgments regarding the use of the work of internal auditors to prevent inappropriate use of such work.

### Conditions Necessary to Use the Work of Internal Audit

AU-C 315 (*Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatements*) addresses how the knowledge and experience of the internal audit function can inform the external auditor's understanding of the entity and its environment, including identification and assessment of risks of material misstatement. AU-C 315 also explains how effective communication between the internal and external auditors creates an environment in which the external auditor can be informed of significant matters that may affect the external auditor's work.

The external auditor may be able to use the work of the internal audit function in a constructive and complementary manner, dependent on:

- Whether the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors,
- The level of competency of the internal audit function, and
- Whether the function applies a systematic and disciplined approach.

SAS-128 addresses the external auditor's responsibilities when, based on the external auditor's understanding of the internal audit function obtained as a result of procedures performed under AU-C 315, the external auditor expects to use the work of the internal audit function in obtaining audit evidence. Such use of that work modifies the nature or timing, or reduces the extent, of audit procedures to be performed directly by the external auditor. SAS-128 also applies

if the external auditor is considering using internal auditors to provide direct assistance under the direction, supervision, and review of the external auditor.

### Evaluating Organizational Status

As part of determining whether the work of internal auditors can be used, SAS-128 also requires the auditor to evaluate whether the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors. "Objectivity" refers to the ability to perform tasks without allowing bias, conflict of interest, or undue influence of others to override professional judgments.

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**OBSERVATION:** The standard of objectivity is different from the standard of independence. Although it could be argued that it is simply a matter of semantics, the differentiation is based on the reasonable assumption that an internal auditor cannot achieve independence, because he or she is an employee of the client.

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Factors that may affect the external auditor's determination about objectivity of internal audit include the following:

- Does the organizational status of the internal audit function support the ability of the function to be free from bias, conflict of interest, or undue influence of others to override professional judgments. For example, does the internal audit function report to:
  - Management, but with direct access to those charged with governance?
  - An officer with appropriate authority?
  - Those charged with governance?
- Is the internal audit function free of any conflicting responsibilities? For example, does internal audit have any managerial or operational duties or responsibilities that are outside the internal audit function?
- Do those charged with governance oversee employment decisions related to the internal audit function?
- Has management or those charged with governance placed any constraints or restrictions on the internal audit function?
- Are internal auditors members of relevant professional organizations that obligate them to comply with standards related to objectivity?

### Evaluating Competence

As part of determining whether the work of internal auditor can be used, SAS-128 requires the auditor to evaluate the competence of the internal audit function. The "competence" of the internal audit function refers to the attainment and maintenance of knowledge and skills of the function as a whole at the level required to enable the assigned tasks to be performed diligently and with the appropriate level of quality.



Factors that may affect the external auditor's determination about competence include the following:

- Is the internal audit function adequately and appropriately resourced relative to the size of the entity and the nature of its operations?
- Do policies for hiring, training, assigning internal auditors to internal audit engagements exist?
- Do internal auditors have adequate training and proficiency in auditing? For example, do they have relevant professional designations and experience?
- Do the internal auditors possess the required knowledge relating to the entity's financial reporting and the applicable financial reporting framework and does the internal audit function possess the necessary skills to perform the work related to the entity's financial statements?
- Are internal auditors members of relevant professional bodies or do they have certifications that oblige them to comply with relevant professional standards, including continuing education requirements?

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**OBSERVATION:** A high level of competence cannot compensate for an organizational status and policies and procedures that do not adequately support the objectivity of the internal auditors. Equally, an organizational status and relevant policies and procedures that adequately support the objectivity of the internal auditors cannot compensate for the lack of sufficient competence of the internal audit function.

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### Evaluating the Application of a Systematic and Disciplined Approach

Consistent with international auditing standards, SAS-128 introduces the concept of "a systematic and disciplined approach." Before being able to use the work of the internal audit function, the auditor must evaluate whether the internal auditor has applied a *systematic and disciplined approach, including quality control* to planning, performing, supervising, reviewing, and documenting its activities that may be performed within the entity.

The following factors may affect the external auditor's determination of whether the internal audit function applies a systematic and disciplined approach:

- Is there any evidence of the existence and use of documented internal audit procedures or guidance covering areas such as risk assessment, work programs, documentation, or reporting?
- Are the procedures adequate and is their nature and extent commensurate with the nature and size of the internal audit function relative to the complexity of the entity?
- Does the internal audit function have appropriate quality control policies and procedures or quality control requirements in standards set by relevant professional bodies for internal auditors? For example, does internal audit have policies and procedures related to leadership, human resources, or engagement performance?

The external auditor's determination of whether the internal audit function applies a systematic and disciplined approach is intended to address the risk that the external auditor inappropriately uses internal audit-like work performed in an informal, unstructured, or ad-hoc manner.

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.

### Determining Nature and Extent of Internal Audit Work to Be Used

To determine the nature and extent of internal audit work that may be used by the external auditor, SAS-128 notes that the external auditor should consider the nature, timing, and extent of the work that has been performed, or is planned to be performed, by the internal audit function, and its relevance to the external auditor's overall audit strategy and audit plan.

Because the external auditor has sole responsibility for the audit opinion expressed, the external auditor should make all significant judgments in the audit engagement, including when using the work of the internal audit function in obtaining audit evidence. As the degree of judgment involved in planning and performing the audit procedures or evaluating audit evidence increases, the need for the external auditor to perform more procedures directly increases.

The work of internal audit may be able to help the external auditor modify the nature or timing, or reduce the extent, of further audit procedures performed directly by the external auditor. For example, the internal audit function may have performed or may be planning to perform tests of relevant controls upon which the external auditor intends to rely in determining the nature, timing, and extent of substantive procedures. Or, the internal audit function may have performed or may be planning to perform substantive procedures that the external auditor also plans to perform. Additionally, the external auditor may be able to coordinate work with the internal auditors and reduce the number of the entity's components where the external auditor would otherwise need to perform audit procedures.

If the external auditor plans to use the work of the internal audit function in obtaining such evidence, the external auditor should discuss the planned use of the work with the function as a basis for coordinating their respective activities. The external auditor should read the reports of the internal audit function that relate to the work of the function the external auditor plans to use to obtain an understanding of the nature and extent of audit procedures the internal audit function performed and the related findings.

The external auditor should perform sufficient audit procedures on the body of work the internal audit function as a whole that the external auditor wants to use to determine its adequacy for purposes of the audit. Those procedures should include the evaluation of whether:

7. If financial statements prepared in accordance with a financial reporting framework generally accepted in another country are also intended for use in the United States, report using the U.S. form of the report and include an emphasis-of-matter paragraph in the report (1) identifying the accounting framework used in preparing the financial statements, (2) referring to the note that describes the framework, and (3) indicating that the framework differs from U.S. GAAP.

## Analysis and Application of Procedures

### Audit Planning and Performance

In auditing financial statements prepared in accordance with a financial reporting framework generally accepted in another country that are prepared for use only outside the United States, GAAS should be complied with excepting requirements related to form and content. However, the procedures applied to perform a GAAS audit may need to be modified to reflect differences in the accounting principles used to prepare the financial statements. For example, some financial reporting frameworks used in foreign countries require, or permit, the revaluation of assets. Auditing such revaluations would differ from an audit of U.S. GAAP-based financial statements.

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**PLANNING AID REMINDER:** If the financial statements prepared in accordance with a framework generally accepted in another country are likely to be used in the United States, the auditor may consider whether U.S. users are likely to understand the differences between the foreign accounting framework and U.S. GAAP. For example, it may not be appropriate to report on financial statements prepared in accordance with a foreign framework if these statements are going to be included in a private placement memorandum that will be used extensively in the United States.

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When the auditor is required to comply with auditing standards of another country, both those standards and GAAS must be observed during the engagement. Thus, some audit procedures will be employed to comply with GAAS, whereas other potentially additional audit procedures will be performed to satisfy auditing standards of the foreign country.

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**PLANNING AID REMINDER:** An understanding of a financial reporting framework generally accepted in another country or the auditing standards of another country or the ISAs may be obtained by reading the statutes or professional literature establishing or describing the framework or standards or by consulting with others with appropriate expertise and experience in applying such framework or standards.

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### Preparing an Appropriate Audit Report

The reporting standards that must be observed in the preparation of the auditor's report on financial statements prepared in accordance with accounting principles of another country are dependent on the purpose of the financial statements. These purposes may be classified as (1) foreign GAAP/foreign use and (2) dual statements (foreign GAAP/U.S. GAAP).

#### Foreign GAAP/Foreign use

When financial statements of a U.S. entity that are prepared in accordance with accounting principles of another country are to be used exclusively outside the United States, the auditor may use either (1) the U.S.-style auditor's report with a statement referencing the note to the financial statements describing the basis of presentation of the financial statements and identifying the nationality of the accounting principles or (2) the standard auditor's report of the foreign country. An example of a U.S.-style auditor's report on financial statements intended for use only outside the United States is presented in Exhibit AU-C 910-2.

The assertions in the standard auditor's report of another country may be different from those in the U.S.-style standard auditor's report. The fundamental assertion in the U.S.-style standard auditor's report is that the financial statements are prepared in accordance with generally accepted accounting principles. On the other hand, a foreign country's standard auditor's report may imply or state that the financial statements are prepared in compliance with existing statutory regulations. Thus, before issuing a foreign country's standard auditor's report, the U.S. auditor must fully understand the auditing standards, accounting principles, and laws that are applicable in the foreign country. To gain the appropriate understanding, the U.S. auditor might need to consult with persons who are familiar with the auditing standards, accounting principles, and laws of the particular foreign country.

#### Dual statements (Foreign GAAP/U.S. GAAP)

One set of financial statements may be prepared in accordance with U.S. GAAP and a second set in accordance with accounting principles acceptable in a foreign country, to provide relevant information to users in both countries. For the financial statements presented in accordance with U.S. GAAP, the auditor should observe GAAS in preparing the auditor's report. For the financial statements prepared in accordance with accounting principles acceptable in a foreign country and to be used outside of the United States, the auditor may prepare either type of report that is permitted for statements using foreign GAAP for use outside the United States.

Some confusion may arise when the same financial statements of a U.S. entity are prepared on two different accounting bases. AU-C 910 suggests that to reduce the possibility of a misunderstanding, one or both of the audit reports may contain a statement advising the reader of the other audit report, which has been issued on the same financial statements but is based on the accepted accounting principles of another country. The auditor's report also may refer to the note to the financial statements, if presented, that describes the significant

differences between the two bases of accounting. An example of the auditor's reference to such a note is as follows:

We also have reported separately on the financial statements of Company X for the same period presented in accordance with [specify the financial reporting framework generally accepted] in [name of country]. (The significant differences between the [specify the financial reporting framework] and accounting principles generally accepted in the United States of America are summarized in Note 1.)

### Practitioner's Aids

Exhibit AU-C 910-1 is an example of a U.S. form of auditor's report on financial statements prepared in accordance with a financial reporting framework generally accepted in another country that are also intended for use in the U.S.

#### EXHIBIT AU-C 910-1—U.S. FORM OF AUDITOR'S REPORT ON FINANCIAL STATEMENTS THAT ARE ALSO INTENDED FOR USE IN THE U.S.

##### INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

#### Report on the Financial Statements

We have audited the accompanying financial statements of X Company, which comprise the balance sheet as of December 31, 20X5, and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements, which, as describe in note X to the financial statements, have been prepared on the basis of [specify the financial reporting framework generally accepted] in [name of country].

#### Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with [specify the financial reporting framework generally accepted] in [name of country]; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

#### Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America (and in [name of country]). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statement 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 the entity's internal

control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

#### Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X5, and the results of its operations or its cash flows for the year then ended in accordance with [specify the financial reporting framework generally accepted] in [name of country].

#### Emphasis of Matter

As discussed in note X to the financial statements, the Company prepares its financial statements in accordance with [specify the financial reporting framework generally accepted] in [name of country], which differ(s) from accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

[Auditor's signature]

[Auditor's city and state]

[Date of the auditor's report]

Exhibit AU-C 910-2 is an example of a U.S. form of auditor's report on financial statements prepared in accordance with a financial reporting framework generally accepted in another country that is intended for use only outside the United States.

#### EXHIBIT AU-C 910-2—U.S. FORM OF AUDITOR'S REPORT ON FINANCIAL STATEMENTS INTENDED FOR USE ONLY OUTSIDE THE U.S.

##### INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

#### Report on the Financial Statements

We have audited the accompanying financial statements of X Company, which comprise the balance sheet as of December 31, 20X5, and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements, which, as described in Note X to the financial statements, have been prepared on the basis of [specify the financial reporting framework generally accepted] in [name of country].

#### Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with [specify the financial reporting framework generally accepted] in [name of country]; this includes the design, implementation, and maintenance of internal control relevant to the preparation and

fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

#### *Auditor's Responsibility*

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America (and in [name of country]). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements 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 the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

#### *Opinion*

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X5, and the results of its operations and its cash flows for the year then ended in accordance with [specify the financial reporting framework generally accepted] in [name of country].

[Auditor's signature]

[Auditor's city and state]

[Date of the auditor's report]

## SECTION 915

### REPORTS ON APPLICATION OF REQUIREMENTS OF AN APPLICABLE FINANCIAL REPORTING FRAMEWORK

#### Authoritative Pronouncements

SAS-122—Statements on Auditing Standards: Clarification and Recodification

SAS-123—Omnibus Statement on Auditing Standards—2011

#### Overview

Accountants are often requested to give an informal opinion on how a transaction should or could be accounted for or what type of opinion would be appropriate for a particular set of financial statements. Requests of this nature are frequently associated with prospective clients who are "shopping for an opinion." Unfortunately, such requests have resulted in a significant amount of adverse publicity for the accounting profession. AU-C 915 provides guidance in this sensitive area. AU-C 915 points out that an accountant may be asked by management or other interested parties (1) to explain how an applicable financial reporting framework applies to specific transactions or (2) to increase their knowledge of specific financial reporting issues.

The standards established by AU-C 915 apply to the reporting accountant and help him or her to appropriately address engagement acceptance, planning, performance, and reporting under the following circumstances:

- A written report is prepared on the application of the requirements of an applicable financial reporting framework to specific transactions.
- A written report is prepared on the type of opinion that may be expressed on a specific entity's financial statements.
- Oral advice is offered that the accountant believes is intended to be used by a principal to the transaction as an important factor to be considered in reaching a decision on the application of the requirements of an applicable financial reporting framework to a specific transaction.
- Oral advice is offered by the reporting accountant on the type of opinion that may be expressed on a specific entity's financial statements.

**OBSERVATION:** The scope of AU-C 915 includes oral advice so that the reporting accountant cannot circumvent professional standards simply by not preparing a written report.

**OBSERVATION:** With the increased visibility of accountants in the press and the related close scrutiny of the profession as well as the possibility of litigation, accountants should be particularly careful in accepting engagements covered by AU-C 915.

The standards established by AU-C 915 do not apply to the following circumstances:

- A continuing accountant with respect to the specific entity whose financial statements are being reported upon by the continuing accountant.
- An accountant assisting in litigation or providing expert testimony involving accounting matters.
- An accountant providing professional advice to another accountant in public practice.
- An accountant preparing other communications such as position papers (newsletters, articles, texts, lectures, etc.) on the application of the requirements of an applicable financial reporting framework to an issue unless the guidance is rendered on a specific transaction.

**OBSERVATION:** The standards established by AU-C 915 do not provide guidance for a continuing accountant (except as discussed later with respect to the communication between the reporting accountant and the continuing accountant) because the continuing accountant discusses the application of accounting principles to various transactions and the effect of the accounting for such transactions on the auditor's report as part of the normal audit process.

### Definitions

|                          |   |
|--------------------------|---|
| Continuing accountant    | An accountant who has been engaged to report on the financial statements of a specific entity.  |
| Hypothetical transaction | A transaction or financial reporting issue that does not involve facts or circumstances of a specific entity.   |
| Reporting accountant     | An accountant, other than a continuing accountant, in the practice of public accounting who prepares a written report or provides oral advice on the application of the requirements of an applicable financial reporting framework to a specific transaction, or on the type of report that may be issued on a specific entity's financial statements. |
| Specific transaction     | A completed or proposed transaction or financial reporting issue involving facts and circumstances of a specific entity.  |
| Written report           | Any written communication expressing a conclusion on the appropriate application of the requirements of an applicable financial reporting framework to a specific transaction, or on the type of report that may be issued on a specific entity's financial statements.   |

### Requirements

The reporting accountant is presumptively required to observe the following performance standards when reporting on the application of requirements of an applicable financial reporting framework:

1. Consider (1) the circumstances under which the written report or oral advice is requested, (2) the purpose of the request, and (3) the intended use of the written report or oral advice in determining whether to accept the engagement. The reporting accountant is not required to be independent.
2. Only accept engagements to issue written reports or provide oral advice on the application of requirements of an applicable financial reporting framework to a specific transaction when the transaction involves facts and circumstances of a specific entity. Engagements to report on hypothetical transactions should not be accepted.
3. Establish an understanding with the entity that management:
  - a. Is responsible for the proper accounting treatment and is expected to consult with its continuing accountant;
  - b. Acknowledges that the reporting accountant may need to consult with the continuing accountant and that management will authorize the continuing accountant to respond fully to the reporting accountant's inquiries upon request; and
  - c. Will notify those charged with governance and the continuing accountant regarding the nature of the engagement.

If management refuses to authorize the continuing accountant to respond fully to the reporting accountant's inquiries, inquire about the reasons and consider the implications in determining whether to accept the engagement.

4. In planning and performing an engagement:
  - a. Obtain an understanding of the form and substance of the specific transactions or the conditions relevant to the type of report that may be issued on a specific entity's financial statements;
  - b. Review the relevant requirements of the applicable financial reporting framework as necessary;
  - c. Consult with other professionals, specialists, or regulators as necessary;
  - d. Perform research or other procedures as appropriate to identify and consider existing creditable precedents or analogies;
  - e. Except as noted in item 5, request permission from the entity's management to consult with the continuing accountant and request the entity's management to authorize the continuing accountant to respond fully to the reporting accountant's inquiries; and
  - f. Except as noted in item 5, consult with the continuing accountant to determine the available facts relevant to forming a conclusion.
5. Consultation with the continuing accountant as described above is not required when the reporting accountant is engaged to issue a written report or provide oral advice on the application of the requirements of an applicable financial reporting framework to a specific transaction and

22. The auditor's opinion on compliance should be modified if (1) the compliance audit identifies noncompliance with the applicable compliance requirements that the auditor believes has a material effect on the entity's compliance or (2) there is a restriction on the scope of the compliance audit.

23. Modify the report on compliance only or the separate report on internal control over compliance when referring to another auditor's report as part of the basis for the report.

24. Communicate in writing to management and those charged with governance any identified significant deficiencies and material weaknesses in internal control over compliance, even if there is no governmental audit requirement to report on internal control over compliance.

25. Communicate to those charged with governance the auditor's responsibilities under GAAS (*Government Auditing Standards*) and the governmental audit requirement, an overview of the planned scope and timing of the compliance audit, and significant findings from the compliance audit.

26. If there is a printed form, schedule, or report containing prescribed wording and the auditor has no basis to make such a statement, he or she should reword the document or attach an appropriately worded separate report.

#### Documentation

27. The auditor should document the following:

- a. Risk assessment procedures performed, including those performed to gain an understanding of internal control over compliance;
- b. The auditor's responses to the assessed risks of material noncompliance, procedures performed, including any tests of controls over compliance, to test compliance with the applicable compliance requirements and the results of those procedures;
- c. Materiality levels and the basis on which they were determined; and
- d. How compliance with the specific governmental audit requirements supplementary to GAAS and *Government Auditing Standards* was achieved.

#### Report Reissuance

28. If a report is reissued, it should include an explanatory paragraph stating the report is replacing a previously issued report, describing the reasons why the report is being reissued, and any changes from the previously issued report. If additional procedures are performed to obtain sufficient appropriate audit evidence for all of the government programs being reported on, the report date should be updated to the date the auditor obtained sufficient appropriate audit evidence about the events causing the auditor to perform the new procedures. If additional procedures are performed to obtain sufficient appropriate audit evidence for some of the government programs being reported on, the report should be dual dated with an updated report date being the date the auditor obtained sufficient appropriate audit evidence regarding the affected government programs and a reference to the affected government programs.

## Analysis and Application of Procedures

### Planning and Performing a Compliance Audit

#### Materiality

In a compliance audit, the auditor establishes materiality levels to:

- Determine the nature and extent of risk assessment procedures;
- Identify and assess the risks of material noncompliance;
- Determine the nature, timing, and extent of further audit procedures;
- Evaluate whether the entity complied with the applicable compliance requirements; and
- Report noncompliance findings and other matters required to be reported by the governmental audit requirement.

Materiality is generally considered in relation to the government program as a whole although a different level of materiality may be specified by the governmental audit requirement for particular purposes. For example, OMB Circular A-133 requires reporting findings of noncompliance that are material in relation to one of fourteen types of compliance requirements identified in the OMB *Compliance Supplement*.

#### Identifying government programs and applicable compliance requirements

Some governmental audit requirements specifically identify the applicable compliance requirements, while others, such as the *Compliance Supplement* for OMB Circular A-133, provide a framework for the auditor to determine the applicable compliance requirements. When identifying and obtaining an understanding of applicable compliance requirements, the auditor may consult the *Compliance Supplement* used in OMB Circular A-133 audits, which contains compliance requirements that are typically applicable to federal government programs and suggested audit procedures for those requirements and also provides guidance for identifying compliance requirements for programs that are not included. The auditor may also consult the applicable program-specific audit guide issued by the grantor agency, which contains the compliance requirements pertaining to the government program and suggested audit procedures for those requirements.

If the *Compliance Supplement* or a program-specific audit guide is not applicable, the auditor may perform the following procedures to identify and obtain an understanding of the applicable compliance requirements:

- Read laws, regulations, rules, and provisions of contracts or grant agreements pertaining to the government program;
- Inquire of management and other knowledgeable entity personnel;
- Inquire of appropriate individuals outside the entity, such as the office of the federal, state, or local program official or auditor about the laws and regulations applicable to entities within their jurisdiction or a third-party specialist such as an attorney;

- Read the minutes of meetings of the governing board of the entity being audited;
- Read audit documentation about the applicable compliance requirements prepared during prior years' audits or other engagements; and
- Discuss the applicable compliance requirements with auditors who performed prior years' audits or other engagements.

#### *Risk assessment and audit procedures*

The nature and extent of risk assessment procedures the auditor performs vary and are influenced by factors such as:

- The newness, complexity, and nature of the applicable compliance requirements;
- The auditor's knowledge of the entity's internal control over compliance with the applicable compliance requirements obtained in previous audits or other professional engagements;
- The services provided by the entity and how they are affected by external factors;
- The level of oversight by the grantor or pass-through entity; and
- How management addresses findings.

In assessing the risks of material noncompliance with the applicable compliance requirements, the auditor may consider the requirements' complexity and susceptibility to noncompliance, how long the entity has been subject to the requirements, how the entity has previously complied with the requirements, the potential effect on the entity of noncompliance, the degree of judgment involved in adhering to the requirements, and the auditor's assessment of the risks of material misstatement in the financial statement audit. Inherent and control risk of noncompliance may be evaluated individually or in combination.

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**OBSERVATION:** The risk of material noncompliance may be pervasive to the entity's noncompliance if an entity is experiencing financial difficulty and there is an increased risk grant funds will be diverted for unauthorized purposes or an entity has a history of poor recordkeeping for its government programs.

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Audit procedures are designed in a compliance audit to detect intentional and unintentional material noncompliance in order to obtain reasonable, but not absolute, assurance about the entity's compliance. Analytical procedures may contribute some substantive evidence, but are generally less effective in a compliance audit than in a financial statement audit. Tests of details may be used to test for compliance in areas such as grant disbursements or expenditures, eligibility files, cost allocation plans, or periodic reports filed with grantor agencies.

Some governmental audit requirements such as OMB Circular A-133 require tests of the operating effectiveness of controls identified as likely to be effective even if that testing is inefficient. For compliance audits, audit evidence about the operating effectiveness of controls obtained in prior audits is not applicable.

#### *Supplementary audit requirements*

An example of supplementary audit requirements the auditor may need to adhere to are the requirements in OMB Circular A-133 to perform specified procedures to identify major programs and to follow up on prior audit findings and perform procedures to assess the reasonableness of the summary schedule of prior audit findings.

#### *Written representations*

Management may include qualifying language in the written representations indicating that representations are made to the best of management's knowledge and belief. This qualifying language is not appropriate for the representations about management's responsibilities for: understanding and complying with the compliance requirements; establishing and maintaining controls that provide reasonable assurance that the entity administers governments programs in accordance with the compliance requirements; and taking corrective action on audit findings of the compliance audit.

#### *Evaluating audit evidence and forming an opinion*

In determining whether an entity has materially complied with the applicable compliance requirements, the auditor may consider factors such as:

- The frequency and nature of noncompliance with the applicable compliance requirements identified during the compliance audit,
- The adequacy of the entity's system for monitoring compliance with the applicable compliance requirements and the possible effect of any noncompliance on the entity, and
- Whether any identified noncompliance with the applicable compliance requirements resulted in likely questioned costs that are material to the government program.

The auditor should consider all noncompliance he or she identified in making this evaluation, regardless of whether the entity corrected the noncompliance after the auditor brought it to management's attention.

#### *Reporting on a Compliance Audit*

The auditor is not precluded from restricting the use of any report to intended users.

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**OBSERVATION:** If a report is a matter of public record or available for public inspection, removing personally identifiable information in the report and findings of noncompliance will reduce the likelihood of sensitive information being disclosed.

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*Government Auditing Standards* require that when the auditor communicates significant deficiencies or material weaknesses in internal control over compliance to management and those charged with governance, he or she obtain a response, preferably in writing, concerning their views on the findings, conclusions, and recommendations included in the auditor's report on internal control

over compliance and any such written response be included in the auditor's report. If the written response is included in a document with the auditor's written communication to management and those charged with governance regarding identified significant deficiencies or material weaknesses in internal control over compliance, the auditor may add a paragraph to the communication disclaiming an opinion on such information.

#### Documentation

Specific documentation of how the auditor adapted and applied each of the applicable AU-C sections to the objectives of a compliance audit is not necessary; documentation of the audit strategy, audit plan, and the work performed is sufficient.

## SECTION 940

### AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING THAT IS INTEGRATED WITH AN AUDIT OF FINANCIAL STATEMENTS

#### Authoritative Pronouncements

SAS-130—An Audit of Internal Control over Financial Reporting That Is Integrated with an Audit of Financial Statements

#### Overview

The basic concepts of internal control and the auditor's consideration of internal control in a financial statement audit are discussed in AU-C 315 (*Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*). Internal control over financial reporting (ICFR) is a process—designed and overseen by those charged with governance, management, and others—designed to provide reasonable assurance that the financial statements are prepared in accordance with the applicable financial reporting framework. Effective internal control provides reasonable assurance over the reliability of financial reporting.

The guidance in AU-C 940 applies only when an auditor is engaged to perform an audit of ICFR that is integrated with a financial statement audit. While integrated audits may be required to be and are often performed by the same auditor, AU-C 940 requires ICFR and financial statement audits to be integrated even if they are performed by different auditors. GAAS standards should be adapted to apply to an ICFR audit that is integrated with a financial statement audit.

The two main objectives of an auditor in an ICFR audit are to:

1. Obtain reasonable assurance about whether material weaknesses exist as of the date specified in management's assessment about ICFR effectiveness; and
2. To express an opinion on the effectiveness of ICFR in a written report and communicate with management and those charged with governance.

The auditor is not required to plan or perform the integrated audit to identify deficiencies less severe than a material weakness. If one or more material weaknesses are found, the entity's ICFR cannot be considered effective. However, the auditor is required to evaluate the effectiveness of all of an entity's relevant control objectives so identification of a material weakness does not relieve the auditor of his or her responsibility to evaluate all remaining relevant control objectives.



**Definitions**

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| Audit of ICFR                                    | An audit of the design and operating effectiveness of an entity's ICFR.  |
| Control objective                                | Control objectives address the risks that specified controls are intended to mitigate. In ICFR, control objectives generally relate to a relevant assertion for a significant class of transactions, account balance, or disclosure and address the risk that the specified controls will not provide reasonable assurance that a misstatement or omission in that assertion is prevented, or detected and corrected, on a timely basis.   |
| Criteria   | Benchmarks used to measure or evaluate the subject matter.   |
| Detective control                                | A control with the objective of detecting and correcting errors or fraud that have occurred and could result in a misstatement of the financial statements.  |
| Internal control over financial reporting (ICFR) | A process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance as to the preparation of reliable financial statements in accordance with the applicable financial reporting framework. ICFR includes policies and procedures that: <ul style="list-style-type: none"> <li>• Pertain to maintaining records that accurately and fairly reflect the transactions and dispositions of the entity's assets;</li> <li>• Provide reasonable assurance that transactions are recorded to allow for financial statement preparation in accordance with the applicable financial reporting framework and that receipts and expenditures are made in accordance with authorizations by management and those charged with governance; and</li> <li>• Provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.</li> </ul> <p>ICFR has inherent limitations due to its reliance on human diligence and compliance, which can lead to lapses in judgments, circumvention by collusion, or improper management override. Because of these limitations, there is a risk that material misstatements will not be prevented, or detected and corrected, on a timely basis by ICFR.</p> <p>The auditor's procedures performed as a part of the integrated audit are not part of an entity's ICFR.</p> |
| Management's assessment about ICFR               | Management's conclusion, which is included in management's report on ICFR, about the effectiveness of the entity's ICFR based on suitable and available criteria.  |
| Preventive control                               | A control with the objective of preventing errors or fraud that could result in a misstatement of the financial statements.  |

**Requirements**

The auditor is presumptively required to perform the following procedures when performing an integrated ICFR audit:

**ICFR Audit Preconditions**

1. Obtain management agreement that it acknowledges and understands its responsibility for:
  - a. Designing, implementing, and maintaining effective ICFR,
  - b. Evaluating the effectiveness of the entity's ICFR using suitable and available criteria,
  - c. Providing management's assessment about ICFR in a report accompanying the auditor's report,
  - d. Supporting its assessment about the effectiveness of the entity's ICFR with sufficient evaluation and documentation, and
  - e. Providing the auditor with access to all information management is aware of that is relevant to management's assessment of ICFR, additional information the auditor may require from management for the ICFR audit, and unrestricted access to the entity's people whom the auditor determines are necessary in obtaining audit evidence.

Determine that the as of date corresponds to the balance sheet or period ending date of the period covered by the financial statements.

2. Evaluate the effectiveness of the entity's ICFR using the same suitable and available criteria used by management in its assessment.

**Requesting a Written Assessment**

3. Request a written assessment from management about the effectiveness of the entity's ICFR. Management's refusal to provide a written assessment is a scope limitation.

**Integrating the ICFR Audit with the Financial Statement Audit**

4. ICFR and financial statement audits have different objectives; however, the integrated audit should be designed to achieve both objectives simultaneously. Tests of controls should be designed to obtain sufficient appropriate audit evidence to support the auditor's opinion on ICFR as of the date specified in management's assessment about ICFR and the auditor's control risk assessments for the financial statement audit.
5. If the ICFR audit engagement is for a period of time, the requirements and guidance in this AU-C should be modified accordingly and the financial statement audit should cover the same period of time.
6. Financial statement auditing procedure results should be taken into account in the auditor's risk assessments and the testing necessary to conclude on the operating effectiveness of a control.
7. If a deficiency in ICFR is identified during the ICFR audit, any effect it has on the nature, timing, and extent of substantive procedures to be performed to reduce audit risk in the financial statement audit to an acceptably low level should be considered.
8. The auditor's conclusion on the effectiveness of controls for the financial statement audit should incorporate the results of any additional tests of controls performed in achieving the objective related to expressing an opinion on the entity's ICFR.

**Planning the ICFR Audit**

9. An overall audit strategy should be established setting the scope, timing, and direction of the ICFR audit and guiding the development of the audit plan in accordance with AU-C 300 (*Planning an Audit*).