Agenda Item 1C

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

Commented [HH1]: Note: file document reflects the management's specialist content from AU-C section 500 to this section. Moved content is shown ***as bold italics***. Changes were made in the following paragraphs: 1, 3, 3a, 26, and A69-A83.

This changes will be consolidated into Appendix B of AU-C section 500 after the ASB meeting.

Introduction

Scope of This Section

.01 This section addresses specific considerations by the auditor in obtaining sufficient appropriate audit evidence, in accordance with section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*; section 500, *Audit Evidence*; and other relevant AU-C sections, regarding certain aspects of (*a*) investments in securities and derivative instruments; (*b*) inventory; (*c*) litigation, claims, and assessments involving the entity; ~~and~~ (*d*) segment information in an audit of financial statements***; and (e)use of management's specialists***.

Effective Date

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

Objective

.03 The objective of the auditor is to obtain sufficient appropriate audit evidence regarding the

a. valuation of investments in securities and derivative instruments;

b. existence and condition of inventory;

c. completeness of litigation, claims, and assessments involving the entity; ~~and~~

d. presentation and disclosure of segment information, in accordance with the applicable financial reporting framework***; and***

e*. *use of management's specialists

Definition

..03a For purposes of GAAS, the following terms have the meanings attributed as follows:

Management's specialist.** **An individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.

Requirements

Investments in Securities and Derivative Instruments (Ref: par. .A1–.A3)

Investments in Securities When Valuations Are Based on the Investee's Financial Results (Excluding Investments Accounted for Using the Equity Method of Accounting)

.04 When investments in securities are valued based on an investee's financial results, excluding investments accounted for using the equity method of accounting, the auditor should obtain sufficient appropriate audit evidence in support of the investee's financial results, as follows: (Ref: par. .A4–.A8)

a. Obtain and read available financial statements of the investee and the accompanying audit report, if any, including determining whether the report of the other auditor is satisfactory for this purpose.

b. If the investee's financial statements are not audited, or if the audit report on such financial statements is not satisfactory to the auditor, apply, or request that the investor entity arrange with the investee to have another auditor apply, appropriate auditing procedures to such financial statements, considering the materiality of the investment in relation to the financial statements of the investor entity.

c. If the carrying amount of the investment reflects factors that are not recognized in the investee's financial statements or fair values of assets that are materially different from the investee's carrying amounts, obtain sufficient appropriate audit evidence in support of such amounts.

d. If the difference between the financial statement period of the entity and the investee has or could have a material effect on the entity's financial statements, determine whether the entity's management has properly considered the lack of comparability and determine the effect, if any, on the auditor's report. (Ref: par. .A9)

If the auditor is not able to obtain sufficient appropriate audit evidence because of an inability to perform one or more of these procedures, the auditor should determine the effect on the auditor's opinion, in accordance with section 705, *Modifications to the Opinion in the Independent Auditor's Report*.

.05 With respect to subsequent events and transactions of the investee occurring after the date of the investee's financial statements but before the date of the auditor's report, the auditor should obtain and read available interim financial statements of the investee and make appropriate inquiries of management of the investor to identify such events and transactions that may be material to the investor's financial statements and that may need to be recognized or disclosed in the investor's financial statements. (Ref: par. .A10)

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

.06 With respect to investments in derivative instruments and securities measured or disclosed at fair value, the auditor should

a. determine whether the applicable financial reporting framework specifies the method to be used to determine the fair value of the entity's derivative instruments and investments in securities and

b. evaluate whether the determination of fair value is consistent with the specified valuation method. (Ref: par. .A11–.A13)

.07 If estimates of fair value of derivative instruments or securities are obtained from broker-dealers or other third-party sources based on valuation models, the auditor should understand the method used by the broker-dealer or other third-party source in developing the estimate and consider the applicability of section 500. [fn 1] (Ref: par. .A14–.A15)

.08 If derivative instruments or securities are valued by the entity using a valuation model, the auditor should obtain sufficient appropriate audit evidence supporting management's assertions about fair value determined using the model. (Ref: par. .A16)

Impairment Losses

.09 The auditor should

a. evaluate management's conclusion (including the relevance of the information considered) about the need to recognize an impairment loss for a decline in a security's fair value below its cost or carrying amount and

b. obtain sufficient appropriate audit evidence supporting the amount of any impairment adjustment recorded, including evaluating whether the requirements of the applicable financial reporting framework have been complied with. (Ref: par. .A17–.A18)

Unrealized Appreciation or Depreciation

.10 The auditor should obtain sufficient appropriate audit evidence about the amount of unrealized appreciation or depreciation in the fair value of a derivative that is recognized

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[fn 1] Paragraph .08 of section 500, *Audit Evidence*, addresses management's specialists.

or that is disclosed because of the ineffectiveness of a hedge, including evaluating whether the requirements of the applicable financial reporting framework have been complied with. (Ref: par. .A19)

Inventory

.11 If inventory is material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding the existence and condition of inventory [fn 2] by

a. attending physical inventory counting, unless impracticable, to (Ref: par. .A20–.A22)

i. evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting, (Ref: par. .A23)

ii. observe the performance of management's count procedures, (Ref: par. .A24)

iii. inspect the inventory, and (Ref: par. .A25)

iv. perform test counts and (Ref: par. .A26)

b. performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results. (Ref: par. .A27–.A30)

.12 If physical inventory counting is conducted at a date other than the date of the financial statements, the auditor should, in addition to the procedures required by paragraph .11, perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are recorded properly. (Ref: par. .A31–.A33)

.13 If the auditor is unable to attend physical inventory counting due to unforeseen circumstances, the auditor should make or observe some physical counts on an alternative date and perform audit procedures on intervening transactions.

.14 If attendance at physical inventory counting is impracticable, the auditor should perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory. If it is not possible to do so, the auditor should

[fn 2] Section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, addresses the auditor's procedures to respond to the assessed risks of material misstatements at the relevant assertion level.

modify the opinion in the auditor's report, in accordance with section 705. (Ref: par. .A34–.A36)

.15 If inventory under the custody and control of a third party is material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:

a. Request confirmation from the third party regarding the quantities and condition of inventory held on behalf of the entity (Ref: par. .A37)

b. Perform inspection or other audit procedures appropriate in the circumstances (Ref: par. .A38)

Litigation, Claims, and Assessments

.16 The auditor should design and perform audit procedures to identify litigation, claims, and assessments involving the entity that may give rise to a risk of material misstatement, including (Ref: par. .A39–.A45)

a. inquiring of management and, when applicable, others within the entity, including in-house legal counsel;

b. obtaining from management a description and evaluation of litigation, claims, and assessments that existed at the date of the financial statements being reported on and during the period from the date of the financial statements to the date the information is furnished, including an identification of those matters referred to legal counsel; [fn 3]

c. reviewing minutes of meetings of those charged with governance; documents obtained from management concerning litigation, claims, and assessments; and correspondence between the entity and its external legal counsel; and

d. reviewing legal expense accounts and invoices from external legal counsel.

.17 For actual or potential litigation, claims, and assessments identified based on the audit procedures required in paragraph .16, the auditor should obtain audit evidence relevant to the following factors:

a. The period in which the underlying cause for legal action occurred

b. The degree of probability of an unfavorable outcome

[fn 3] For purposes of this section, the term *legal counsel* refers to the entity's in-house legal counsel and external legal counsel.

c. The amount or range of potential loss

Communication With the Entity's Legal Counsel

.18 Unless the audit procedures required by paragraph .16 indicate that no actual or potential litigation, claims, or assessments that may give rise to a risk of material misstatement exist, the auditor should, in addition to the procedures required by other AU-C sections, seek direct communication with the entity's external legal counsel. The auditor should do so through a letter of inquiry prepared by management and sent by the auditor requesting the entity's external legal counsel to communicate directly with the auditor. (Ref: par. .A40 and .A46–.A63)

.19 In addition to the direct communications with the entity's external legal counsel referred to in paragraph .18, the auditor should, in cases when the entity's in-house legal counsel has the responsibility for the entity's litigation, claims, and assessments, seek direct communication with the entity's in-house legal counsel through a letter of inquiry similar to the letter referred to in paragraph .18. Audit evidence obtained from in-house legal counsel in this manner is not, however, a substitute for the auditor seeking direct communication with the entity's external legal counsel, as described in paragraph .18. (Ref: par. .A64)

.20 The auditor should document the basis for any determination not to seek direct communication with the entity's legal counsel, as required by paragraphs .18–.19.

.21 The auditor should request management to authorize the entity's legal counsel to discuss applicable matters with the auditor.

.22 As described in paragraphs .18–.19, the auditor should request, through letter(s) of inquiry, the entity's legal counsel to inform the auditor of any litigation, claims, assessments, and unasserted claims that the counsel is aware of, together with an assessment of the outcome of the litigation, claims, and assessments, and an estimate of the financial implications, including costs involved. Each letter of inquiry should include, but not be limited to, the following matters: (Ref: par. .A69)

a. Identification of the entity, including subsidiaries, and the date of the audit

b. A list prepared by management (or a request by management that the legal counsel prepare a list) that describes and evaluates pending or threatened litigation, claims, and assessments with respect to which the legal counsel has been engaged and to which the legal counsel has devoted substantive attention on behalf of the company in the form of legal consultation or representation

c. A list prepared by management that describes and evaluates unasserted claims and assessments that management considers to be probable of assertion and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome with respect to which the legal counsel has been engaged and to which the legal counsel has devoted substantive attention on behalf of the entity in the form of legal consultation or representation

d. Regarding each matter listed in item *b*, a request that the legal counsel either provide the following information or comment on those matters on which the legal counsel's views may differ from those stated by management, as appropriate:

i. A description of the nature of the matter, the progress of the case to date, and the action that the entity intends to take (for example, to contest the matter vigorously or to seek an out-of-court settlement)

ii. An evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss (Ref: par. .A65)

iii. With respect to a list prepared by management (or by the legal counsel at management's request), an identification of the omission of any pending or threatened litigation, claims, and assessments or a statement that the list of such matters is complete

e. Regarding each matter listed in item *c*, a request that the legal counsel comment on those matters on which the legal counsel's views concerning the description or evaluation of the matter may differ from those stated by management

f. A statement that management understands that whenever, in the course of performing legal services for the entity with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, the legal counsel has formed a professional conclusion that the entity should disclose or consider disclosure concerning such possible claim or assessment, the legal counsel, as a matter of professional responsibility to the entity, will so advise the entity and will consult with the entity concerning the question of such disclosure and the requirements of the applicable financial reporting framework (for example, the requirements of Financial Accounting Standards Board [FASB] *Accounting Standards Codification* [ASC] 450, *Contingencies*)

g. A request that the legal counsel confirm whether the understanding described in item *f* is correct

h. A request that the legal counsel specifically identify the nature of, and reasons for, any limitation on the response

i. A request that the legal counsel specify the effective date of the response

.23 When the auditor is aware that an entity has changed legal counsel or that the legal counsel previously engaged by the entity has resigned, the auditor should consider making inquiries of management or others about the reasons such legal counsel is no longer associated with the entity. (Ref: par. .A55)

.24 The auditor should modify the opinion in the auditor's report, in accordance with section 705, if (Ref: par. .A56–.A65)

a. the entity's legal counsel refuses to respond appropriately to the letter of inquiry and the auditor is unable to obtain sufficient appropriate audit evidence by performing alternative audit procedures or

b. management refuses to give the auditor permission to communicate or meet with the entity's external legal counsel.

Segment Information

.25 The auditor should obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information, in accordance with the applicable financial reporting framework, by (Ref: par. .A66–.A67)

a. obtaining an understanding of the methods used by management in determining segment information and (Ref: par. .A68)

i. evaluating whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework and

ii. when appropriate, testing the application of such methods and

b. performing analytical procedures or other audit procedures appropriate in the circumstances.

Use of Management's Specialists

.26 If information to be used as audit evidence has been prepared using the work of a management's specialist, the auditor should, to the extent necessary, taking into account the significance of that specialist's work for the auditor's purposes, (Ref: par. .A69–.A71)

a. evaluate the competence, capabilities, and objectivity of that specialist; (Ref: par. A72–.A78)

b. obtain an understanding of the work of that specialist; and (Ref: par .A79–.A82)

c. evaluate the appropriateness of that specialist's work as audit evidence for the relevant assertion. (Ref: .A83)

Application and Other Explanatory Material

Investments in Securities and Derivative Instruments (Ref: par. .04–.10)

.A1 Evaluating audit evidence for assertions about investments in securities and derivative instruments may involve professional judgment because the assertions, especially those about valuation, are based on highly subjective assumptions or are particularly sensitive to changes in the underlying circumstances. Valuation assertions may be based on assumptions about the occurrence of future events for which expectations are difficult to develop or on assumptions about conditions expected to exist over a long period (for example, default rates or prepayment rates). Accordingly, competent persons could reach different conclusions about estimates of fair values or estimates of ranges of fair values. Professional judgment also may be necessary when evaluating audit evidence for assertions based on features of the security or derivative and the requirements of the applicable financial reporting framework, including underlying criteria for hedge accounting, which are extremely complex. For example, determining the fair value of a structured note may require consideration of a variety of features of the note that react differently to changes in economic conditions. In addition, one or more other derivatives may be designated to hedge changes in cash flows under the note. Evaluating audit evidence about the fair value of the note, the determination of whether the hedge is highly effective, and the allocation of changes in fair value to earnings and other comprehensive income requires professional judgment.

.A2 This section addresses only certain specific aspects relating to auditing valuation of investments in securities and derivative instruments. Section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, addresses the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates and related disclosures in an audit of financial statements. The Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* provides additional and more detailed guidance to auditors related to planning and performing auditing procedures for assertions about derivative instruments, hedging activities, and investments in securities.

Investments in Securities When Valuations Are Based on Cost

.A3 Procedures to obtain evidence about the valuation of securities that are recorded at cost may include inspection of documentation of the purchase price, confirmation with the issuer or holder of those securities, and testing discount or premium amortization either by recomputation or through the use of analytical procedures. [Revised, February 2017, to better reflect the AICPA Council Resolution designating the PCAOB to promulgate technical standards.]

Investments in Securities When Valuations Are Based on the Investee's Financial Results (Excluding Investments Accounted for Using the Equity Method of Accounting) (Ref: par. .04–.05)

.A4 Section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, addresses auditing investments accounted for using the equity method of accounting.

.A5 For valuations based on an investee's financial results (excluding investments accounted for using the equity method of accounting), obtaining and reading the financial statements of the investee that have been audited by an auditor whose report is satisfactory may be sufficient for the purpose of obtaining sufficient appropriate audit evidence. In determining whether the report of another auditor is satisfactory, the auditor may perform procedures such as making inquiries regarding the professional reputation and standing of the other auditor, visiting the other auditor, discussing the audit procedures followed and the results thereof, and reviewing the audit plan and audit documentation of the other auditor.

.A6 After obtaining and reading the audited financial statements of an investee, the auditor may conclude that additional audit procedures are necessary to obtain sufficient appropriate audit evidence. For example, the auditor may conclude that additional audit evidence is needed because of significant differences in fiscal year-ends, significant differences in accounting principles, changes in ownership, or the significance of the investment to the investor's financial position or results of operations. Examples of procedures that the auditor may perform are reviewing information in the investor's files that relates to the investee, such as investee minutes and budgets, and investee cash flow information and making inquiries of investor management about the investee's financial results.

.A7 The auditor may need to obtain evidence relating to transactions between the entity and investee to evaluate

a. the propriety of the elimination of unrealized profits and losses on transactions between the entity and investee, if applicable, and

b. the adequacy of disclosures about material related party transactions or relationships.

.A8 Section 540 and paragraphs .06–.08 of this section address auditing fair value accounting estimates. The Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* also provides guidance on audit evidence that may be relevant to the fair value of derivative instruments and securities and on procedures that may be performed by the auditor to evaluate management's consideration of the need to recognize impairment losses.

.A9 The date of the investor's financial statements and those of the investee may be different. If the difference between the date of the entity's financial statements and those of the investee has or could have a material effect on the entity's financial statements, the auditor is required, in accordance with paragraph .04*d*, to determine whether the entity's management has properly considered the lack of comparability. The effect may be material, for example, because the difference between the financial statement period ends of the entity and investee is not consistent with the prior period in comparative statements or because a significant transaction occurred during the time period between the financial statement period end of the entity and investee. If a change in the difference between the financial statement period end of the entity and investee has a material effect on the investor's financial statements, the auditor may be required, in accordance with section

708, *Consistency of Financial Statements*, to add an emphasis-of-matter paragraph to the auditor's report because the comparability of financial statements between periods has been materially affected by a change in reporting period.

.A10 Section 560, *Subsequent Events and Subsequently Discovered Facts*, addresses the auditor's responsibilities relating to subsequent events and subsequently discovered facts in an audit of financial statements.

Investments in Derivative Instruments and Securities Measured or Disclosed at Fair Value (Ref: par. .06–.08)

.A11 The method for determining fair value may be specified by the applicable financial reporting framework and may vary depending on the industry in which the entity operates or the nature of the entity. Such differences may relate to the consideration of price quotations from inactive markets and significant liquidity discounts, control premiums, and commissions and other costs that would be incurred to dispose of the derivative instrument or security.

.A12 If the determination of fair value requires the use of accounting estimates, see section 540, which addresses auditing fair value accounting estimates, including requirements and guidance relating to the auditor's understanding of the applicable financial reporting framework relevant to accounting estimates and the method used in making the estimate [fn 4] and the auditor's determination of whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate. [fn 5] The Audit Guide *Special Considerations in Auditing Financial Instruments* also provides guidance on audit evidence that may be relevant to the fair value of derivative instruments and investments in securities.

.A13 Quoted market prices for derivative instruments and securities listed on national exchanges or over-the-counter markets are available from sources such as financial publications, the exchanges, NASDAQ, or pricing services based on sources such as those. Quoted market prices obtained from those sources generally provide sufficient evidence of the fair value of the derivative instruments and securities.

.A14 For certain other derivative instruments and securities, quoted market prices may be obtained from broker-dealers who are market makers in them or through the National Quotation Bureau. However, using such a price quote to test valuation assertions may require special knowledge to understand the circumstances in which the quote was

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fn 4 Paragraphs .08*a*, .08*c*, .A12–.A14, and .A23–.A25 of section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*.

fn 5 Paragraphs .12*a* and .A53–.A57 of section 540.

developed. For example, quotations published by the National Quotation Bureau may not be based on recent trades and may be only an indication of interest and not an actual price for which a counterparty will purchase or sell the underlying derivative instrument or security.

.A15 If quoted market prices are not available for the derivative instrument or security, estimates of fair value frequently may be obtained from broker-dealers or other third-party sources, based on proprietary valuation models, or from the entity, based on internally or externally developed valuation models (for example, the Black-Scholes option pricing model). Understanding the method used by the broker-dealer or other third-party source in developing the estimate may include, for example, understanding whether a pricing model or cash flow projection was used. The auditor also may determine that it is necessary to obtain estimates from more than one pricing source. For example, this may be appropriate if either of the following occurs:

- The pricing source has a relationship with an entity that might impair its objectivity, such as an affiliate or a counterparty involved in selling or structuring the product.
- The valuation is based on assumptions that are highly subjective or particularly sensitive to changes in the underlying circumstances.

See also section 540. [fn 6]

.A16 Examples of valuation models include the present value of expected future cash flows, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Refer to section 540 for the auditor's procedures to obtain evidence supporting management's assertions about fair value that are determined using a valuation model.

Impairment Losses (Ref: par. .09)

.A17 Regardless of the valuation method used, the applicable financial reporting framework might require recognizing, in earnings or other comprehensive income, an impairment loss for a decline in fair value that is other than temporary. Determinations of whether losses are other than temporary may involve estimating the outcome of future events and making judgments in determining whether factors exist that indicate that an impairment loss has been incurred at the end of the reporting period. These judgments are based on subjective as well as objective factors, including knowledge and experience about past and current events and assumptions about future events. The following are examples of such factors:

[fn 6] Paragraphs .A68–.A89 of section 540.

- Fair value is significantly below cost or carrying value and
  - the decline is attributable to adverse conditions specifically related to the security or specific conditions in an industry or a geographic area.
  - the decline has existed for an extended period of time.
  - for an equity security, management has the intent to sell the security or it is more likely than not that it will be required to sell the security before recovery.
  - for a debt security, management has the intent to sell the security or it is more likely than not it will be required to sell the security before the security's anticipated recovery of its amortized cost basis (for example, if the entity's cash or working capital requirements or contractual or regulatory obligations indicate that the debt security will be required to be sold before the forecasted recovery occurs).
- The security has been downgraded by a rating agency.
- The financial condition of the issuer of those securities has deteriorated.
- Dividends have been reduced or eliminated or scheduled interest payments have not been made.
- The entity recorded losses from the security subsequent to the end of the reporting period.

[Revised, February 2017, to better reflect the AICPA Council Resolution designating the PCAOB to promulgate technical standards.]

.A18 Evaluating the relevance of the information considered may include obtaining evidence about factors such as those referred to in paragraph .A17 that tend to corroborate or conflict with management's conclusions.

Unrealized Appreciation or Depreciation (Ref: par. .10)

.A19 Obtaining audit evidence about the amount of unrealized appreciation or depreciation in the fair value of a derivative that is recognized or that is disclosed because of the ineffectiveness of a hedge may include understanding the methods used to determine whether the hedge is highly effective and to determine the ineffective portion of the hedge.

Inventory

Attendance at Physical Inventory Counting (Ref: par. .11a)

.A20 Management ordinarily establishes procedures under which inventory is physically counted at least once per year to serve as a basis for the preparation of the financial statements and, if applicable, to ascertain the reliability of the entity's perpetual inventory system.

.A21 Attendance at physical inventory counting involves

- inspecting the inventory to ascertain its existence and evaluate its condition and performing test counts,
- observing compliance with management's instructions and the performance of procedures for recording and controlling the results of the physical inventory count, and
- obtaining audit evidence about the reliability of management's count procedures.

These procedures may serve as tests of controls or substantive procedures, or both, depending on the auditor's risk assessment, planned approach, and the specific procedures carried out.

.A22 Matters relevant in planning attendance at physical inventory counting (or in designing and performing audit procedures pursuant to paragraphs .11–.15) include, for example, the following:

- The risks of material misstatement related to inventory.
- The control risk related to inventory.
- Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.
- The timing of physical inventory counting.
- Whether the entity maintains a perpetual inventory system.
- The locations at which inventory is held, including the materiality of the inventory and the risks of material misstatement at different locations, in deciding at which locations attendance is appropriate. Section 600 addresses the involvement of component auditors and, accordingly, may be relevant if such involvement is with regard to attendance of physical inventory counting at a remote location.
- Whether the assistance of an auditor's specialist is needed. Section 620, *Using the Work of an Auditor's Specialist*, addresses the use of an auditor's specialist to assist the auditor in obtaining sufficient appropriate audit evidence.

Evaluate Management's Instructions and Procedures (Ref: par. .11a(i))

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

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

Observe the Performance of Management's Count Procedures (Ref: par. .11a(ii))

.A24 Observing the performance of management's count procedures (for example, those relating to control over the movement of inventory before, during, and after the count) assists the auditor in obtaining audit evidence that management's instructions and count procedures are designed and implemented adequately. In addition, the auditor may obtain copies of cutoff information, such as details of the movement of inventory, to assist the auditor in performing audit procedures over the accounting for such movements at a later date.

Inspect the Inventory (Ref: par. .11a(iii))

.A25 Inspecting inventory when attending physical inventory counting assists the auditor in ascertaining the existence of the inventory (though not necessarily its ownership) and in identifying obsolete, damaged, or aging inventory.

Perform Test Counts (Ref: par. .11a(iv))

.A26 Performing test counts (for example, by tracing items selected from management's count records to the physical inventory and tracing items selected from the physical inventory to management's count records) provides audit evidence about the completeness and accuracy of those records.

.A27 In addition to recording the auditor's test counts, obtaining copies of management's completed physical inventory count records assists the auditor in performing subsequent audit procedures to determine whether the entity's final inventory records accurately reflect actual inventory count results.

Use of Management's Specialists

.A28 Management may engage specialists who have expertise in the taking of physical inventories to count, list, price, and subsequently compute the total dollar amount of inventory on hand at the date of the physical count. For example, entities such as retail stores, hospitals, and automobile dealers may use specialists in this manner.

.A29 An inventory count performed by an external inventory firm engaged as a management specialist does not, by itself, provide the auditor with sufficient appropriate audit evidence. The auditor is required by section 500 to perform certain procedures if information to be used as audit evidence has been prepared using the work of a management's specialist.[fn 7] The auditor may, for example, examine the specialist's program, observe its procedures and controls, make or observe some physical counts of the inventory, recompute calculations of the submitted inventory on a test basis, and apply appropriate tests to the intervening transactions.

.A30 Although the auditor may adjust the extent of the work on the physical count of inventory because of the work of management's specialist, any restriction imposed on the auditor such that the auditor is unable to perform the procedures that the auditor considers necessary is a scope limitation. In such cases, section 705 requires the auditor to modify the opinion in the auditor's report as a result of the scope limitation.

Physical Inventory Counting Conducted Other Than at the Date of the Financial Statements (Ref: par. .12)

.A31 For practical reasons, the physical inventory counting may be conducted at a date, or dates, other than the date of the financial statements. This may be done irrespective of whether management determines inventory quantities by an annual physical inventory counting or maintains a perpetual inventory system. In either case, the effectiveness of the design, implementation, and maintenance of controls over changes in inventory determines whether the conduct of physical inventory counting at a date (or dates) other than the date of the financial statements is appropriate for audit purposes. Section 330 addresses substantive procedures performed at an interim date.[fn 8]

.A32 When a perpetual inventory system is maintained, management may perform physical counts or other tests to ascertain the reliability of inventory quantity information included in the entity's perpetual inventory records. In some cases, management or the auditor may identify differences between the perpetual inventory records and actual physical inventory quantities on hand; this may indicate that the controls over changes in inventory are not operating effectively.

[fn 7] Paragraph .08 of section 500 addresses management's specialists.

[fn 8] Paragraphs .23–.24 of section 330.

.A33 Relevant matters for consideration when designing audit procedures to obtain audit evidence about whether changes in inventory amounts between the count date, or dates, and the final inventory records are recorded properly include the following:

- Whether the perpetual inventory records are properly adjusted
- Reliability of the entity's perpetual inventory records
- Reasons for significant differences between the information obtained during the physical count and the perpetual inventory records

Attendance at Physical Inventory Counting Is Impracticable (Ref: par. .14)

.A34 In some cases, attendance at physical inventory counting may be impracticable. This may be due to factors such as the nature and location of the inventory (for example, when inventory is held in a location that may pose threats to the safety of the auditor). The matter of general inconvenience to the auditor, however, is not sufficient to support a decision by the auditor that attendance is impracticable. Further, as explained in section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, the matter of difficulty, time, or cost involved is not, in itself, a valid basis for the auditor to omit an audit procedure for which no alternative exists or to be satisfied with audit evidence that is less than persuasive.

.A35 In some cases, when attendance is impracticable, alternative audit procedures (for example, observing a current physical inventory count and reconciling it to the opening inventory quantities or inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory counting) may provide sufficient appropriate audit evidence about the existence and condition of inventory. If the audit covers the current period and one or more periods for which the auditor had not observed or made some physical counts of prior inventories, alternative audit procedures, such as tests of prior transactions or reviews of the records of prior counts, may provide sufficient appropriate audit evidence about the prior inventories. The effectiveness of the alternative procedures that an auditor may perform is affected by the length of the period that the alternative procedures cover.

.A36 In other cases, however, it may not be possible to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by performing alternative audit procedures. In such cases, section 705 requires the auditor to modify the opinion in the auditor's report as a result of the scope limitation. In addition, section 510, *Opening Balances—Initial Audit Engagements, Including Reaudit Engagements*, addresses the auditor's procedures regarding inventory opening balances in initial audit engagements. [fn 9]

Inventory Under the Custody and Control of a Third Party

Confirmation (Ref: par. .15a)

.A37 Section 505, *External Confirmations*, addresses external confirmation procedures.

Other Audit Procedures (Ref: par. .15*b*)

.A38 Depending on the circumstances (for example, when information is obtained that raises doubt about the integrity and objectivity of the third party), the auditor may consider it appropriate to perform other audit procedures instead of, or in addition to, confirmation with the third party. Examples of other audit procedures include the following:

- Attending, or arranging for another auditor to attend, the third party's physical counting of inventory, if practicable
- Obtaining another auditor's report on the adequacy of the third party's internal control for ensuring that inventory is properly counted and adequately safeguarded
- Inspecting documentation regarding inventory held by third parties (for example, warehouse receipts)
- Requesting confirmation from other parties when inventory has been pledged as collateral

Litigation, Claims, and Assessments

Completeness of Litigation, Claims, and Assessments (Ref: par. .16)

.A39 Litigation, claims, and assessments involving the entity may have a material effect on the financial statements and, thus, may be required to be recognized, measured, or disclosed in the financial statements.

.A40 Other legal matters involving the entity may not have a material effect on the entity's financial statements and, accordingly, would not give rise to risks of material misstatement. Examples of such other legal matters may be

fn 9 Paragraph .A13 of section 510, *Opening Balances—Initial Audit Engagements, Including Reaudit Engagements*.

- matters unrelated to actual or potential litigation, claims, or assessments, such as consulting services related to real estate or potential merger and acquisition transactions;

- matters in which the entity records indicate that management or the legal counsel has not devoted substantive attention to the matter;

- matters in which the entity's insurance coverage exceeds the amount of the actual or potential litigation, claim, or assessment sought against the entity; or

- matters that are clearly trivial to the financial statements.

.A41 Management is responsible for adopting policies and procedures to identify, evaluate, and account for litigation, claims, and assessments as a basis for the preparation of financial statements, in accordance with the requirements of the applicable financial reporting framework.

.A42 Management is the primary source of information about events or conditions considered in the financial accounting for, and reporting of, litigation, claims, and assessments because these matters are within the direct knowledge and, often, control of management. Accordingly, the auditor's procedures with respect to litigation, claims, and assessments include the following:

- Making inquiries of management as required by paragraph .16*a*, which may include a discussion about the policies and procedures adopted for identifying, evaluating, and accounting for litigation, claims, and assessments involving the entity that may give rise to a risk of material misstatement

- Obtaining written representations from management, in accordance with section 580, *Written Representations*, that all known actual or possible litigation, claims, and assessments whose effects should be considered when preparing the financial statements have been disclosed to the auditor and accounted for and disclosed in accordance with the applicable financial reporting framework [fn 10]

.A43 In addition to the procedures identified in paragraph .16, other relevant procedures include, for example, using information obtained through risk assessment procedures carried out as part of obtaining an understanding of the entity and its environment to assist the auditor to become aware of litigation, claims, and assessments involving the entity. Examples of such procedures are as follows:

[fn 10] Paragraph .15 of section 580, *Written Representations*.

- Reading minutes of meetings of stockholders; directors; governing bodies of governmental entities; and appropriate committees held during, and subsequent to, the period being audited

- Reading contracts, loan agreements, leases, correspondence from taxing or other governmental agencies, and similar documents

- Obtaining information concerning guarantees from bank confirmation forms

- Inspecting other documents for possible guarantees by the entity

Section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, requires the auditor to obtain an understanding of the entity and its environment.[fn 11] In addition, section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, requires the auditor to obtain an understanding of the entity's legal and regulatory framework applicable to the entity and industry or sector in which the entity operates and how the entity is complying with that framework.

.A44 Audit evidence obtained for purposes of identifying litigation, claims, and assessments that may give rise to a risk of material misstatement also may provide audit evidence regarding other relevant considerations, such as valuation or measurement, regarding litigation, claims, and assessments. Section 540 establishes requirements and provides guidance relevant to the auditor's consideration of litigation, claims, and assessments requiring accounting estimates or related disclosures in the financial statements.

.A45 This section addresses inquiries of the entity's legal counsel with whom management has consulted. If management has not consulted legal counsel, the auditor would rely on the procedures required by paragraph .16 to identify litigation, claims, and assessments involving the entity, which may give rise to a risk of material misstatement, and the written representation of management regarding litigation, claims, and assessments, as required by section 580.

Communication With the Entity's Legal Counsel (Ref: par. .18–.24)

.A46 An auditor ordinarily does not possess legal skills and, therefore, cannot make legal judgments concerning information coming to the auditor's attention.

.A47 Direct communication with the entity's legal counsel assists the auditor in obtaining sufficient appropriate audit evidence about whether potentially material litigation, claims, and assessments are known and management's estimates of the financial implications, including costs, are reasonable.

[fn 11] Paragraph .12 of section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.

.A48 The American Bar Association (ABA) has approved *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information* (the ABA statement), which explains the concerns of the legal counsel and the nature of the limitations that an auditor is likely to encounter in connection with seeking direct communication with the entity's legal counsel about litigation, claims, assessments, and unasserted claims. [fn 12]

.A49 A letter of inquiry to the entity's legal counsel is the auditor's primary means of obtaining corroboration of the information provided by management concerning material litigation, claims, and assessments. Audit evidence obtained from the entity's in-house general counsel or legal department may provide the auditor with the necessary corroboration.

.A50 In certain circumstances, the auditor also may judge it necessary to meet with the entity's legal counsel to discuss the likely outcome of the litigation or claims. This may be the case, for example, when

- the auditor determines that the matter is a significant risk.
- the matter is complex.
- a disagreement exists between management and the entity's external legal counsel.

Ordinarily, such meetings require management's permission and are held with a representative of management in attendance.

.A51 An external legal counsel's response to a letter of inquiry and the procedures set forth in paragraphs .16–.17 provide the auditor with sufficient appropriate audit evidence concerning the accounting for, and reporting of, pending and threatened litigation, claims, and assessments.

.A52 Audit evidence about the status of litigation, claims, and assessments up to the date of the auditor's report may be obtained by inquiry of management, including in-house legal counsel responsible for dealing with the relevant matters. The auditor may need to obtain updated information from the entity's legal counsel.

.A53 In accordance with section 700, *Forming an Opinion and Reporting on Financial Statements*, the auditor is required to date the auditor's report no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the

[fn 12] The *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information* is reprinted as exhibit A, "American Bar Association Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information," for the convenience of readers but is not an integral part of this section.

auditor's opinion on the financial statements. [fn 13] Accordingly, it is preferable that the entity's legal counsel's response be as close to the date of the auditor's report as is practicable in the circumstances. Specifying the effective date of the entity's legal counsel's response to reasonably approximate the expected date of the auditor's report may obviate the need to obtain updated information from the entity's legal counsel.

.A54 Clearly specifying the earliest acceptable effective date of the response and the latest date by which it is to be sent to the auditor and informing the entity's legal counsel of these dates timely facilitates the entity's legal counsel's ability to respond timely and adequately. A two-week period between the specified effective date of the entity's legal counsel's response and the latest date by which the response is to be sent to the auditor is generally sufficient.

.A55 In some circumstances, the legal counsel may be required by relevant ethical requirements to resign the engagement if the legal counsel's advice concerning financial accounting and reporting for litigation, claims, and assessments is disregarded by the entity.

.A56 The legal counsel appropriately may limit the response to matters to which the legal counsel has given substantive attention in the form of legal consultation or representation. Also, the legal counsel's response may be limited to matters that are considered individually or collectively material to the financial statements, such as when the entity and auditor have reached an understanding on the limits of materiality for this purpose and management has communicated such understanding to the legal counsel. Such limitations are not limitations on the scope of the audit.

.A57 The legal counsel may be unable to respond concerning the likelihood of an unfavorable outcome of litigation, claims, and assessments or the amount or range of potential loss because of inherent uncertainties. Factors influencing the likelihood of an unfavorable outcome sometimes may not be within the legal counsel's competence to judge; historical experience of the entity in similar litigation or the experience of other entities may not be relevant or available, and the amount of the possible loss frequently may vary widely at different stages of litigation. Consequently, the legal counsel may not be able to form a conclusion with respect to such matters. In such circumstances, the auditor may conclude that the financial statements are affected by an uncertainty concerning the outcome of a future event that cannot be reasonably estimated. If the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement, section 705 requires the auditor to modify the

[fn 13] Paragraph .41 of section 700, *Forming an Opinion and Reporting on Financial Statements*.

opinion in addressing the effect, if any, of the legal counsel's response on the auditor's report as a result of the scope limitation. [fn 14]

.A58 An external legal counsel's refusal to furnish the information requested in an inquiry letter either in writing or orally may cause a scope limitation of the audit sufficient to preclude an unmodified opinion.

.A59 Although the auditor would consider the inability to review information that could have a significant bearing on the audit as a scope limitation, in recognition of the public interest in protecting the confidentiality of lawyer-client communications, such inability is not intended to require an auditor to examine documents that the client identifies as subject to the lawyer-client privilege. In the event of questions concerning the applicability of this privilege, the auditor may request confirmation from the entity's legal counsel that the information is subject to that privilege and that the information was considered by the legal counsel in responding to the letter of inquiry or, if the matters are being handled by another legal counsel, an identification of such legal counsel for the purpose of sending a letter of inquiry.

.A60 If management imposes a limitation on the scope of the audit and the auditor is unable to obtain sufficient appropriate audit evidence by performing alternative audit procedures, the auditor is required by section 705 to either disclaim an opinion on the financial statements or, when practicable, withdraw from the audit. [fn 15]

.A61 In some cases, in order to emphasize the preservation of the attorney-client privilege or the attorney work-product privilege, some entities may include the following or substantially similar language in the audit inquiry letter to legal counsel:

> We do not intend that either our request to you to provide information to our auditor or your response to our auditor should be construed in any way to constitute a waiver of the attorney-client privilege or the attorney work-product privilege.

For the same reason, some legal counsel may include the following or substantially similar language in their response letters to auditors:

> The Company [*or other defined term*] has advised us that, by making the request set forth in its letter to us, the Company [*or other defined term*] does not intend to waive the attorney-client privilege with respect to any information which the Company [*or other defined term*] has furnished to us. Moreover, please be

[fn 14] Paragraph .07 of section 705, *Modifications to the Opinion in the Independent Auditor's Report*.

[fn 15] Paragraph .13 of section 705.

> advised that our response to you should not be construed in any way to constitute a waiver of the protection of the attorney work-product privilege with respect to any of our files involving the Company [*or other defined term*].

Explanatory language similar to the foregoing in the letters of the entity or legal counsel is not a limitation on the scope of the legal counsel's response. See exhibit B, "Report of the Subcommittee on Audit Inquiry Responses."

.A62 In order to emphasize the preservation of the attorney-client privilege with respect to unasserted possible claims or assessments, some legal counsel may include the following or substantially similar language in their responses to audit inquiry letters:

> Please be advised that pursuant to clauses (b) and (c) of Paragraph 5 of the ABA Statement of Policy [*American Bar Association's Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information*] and related Commentary referred to in the last paragraph of this letter, it would be inappropriate for this firm to respond to a general inquiry relating to the existence of unasserted possible claims or assessments involving the Company. We can only furnish information concerning those unasserted possible claims or assessments upon which the Company has specifically requested in writing that we comment. We also cannot comment upon the adequacy of the Company's listing, if any, of unasserted possible claims or assessments or its assertions concerning the advice, if any, about the need to disclose same.

Additional language similar to the foregoing in a letter from legal counsel is not a limitation on the scope of the audit. However, the ABA statement and the understanding between the legal and accounting professions assumes that the legal counsel, under certain circumstances, will advise and consult with the entity concerning the entity's obligation to make financial statement disclosure with respect to unasserted possible claims or assessments. Confirmation of this understanding is included in the legal counsel's response.

.A63 If the auditor believes that there may be actual or potential material litigation, claims, or assessments and the entity has not engaged external legal counsel relating to such matters, the auditor may discuss with the client the possible need to consult legal counsel to assist the client in determining the appropriate measurement, recognition, or disclosure of related liabilities or loss contingencies in the financial statements, in accordance with the applicable financial reporting framework. Depending on the significance of the matter(s), refusal by management to consult legal counsel in these circumstances may result in a scope limitation of the audit sufficient to preclude an unmodified opinion.

Direct Communication With the Entity's In-House Legal Counsel

.A64 In-house legal counsel can range from one lawyer to a large staff, with responsibilities ranging from specific internal matters to a comprehensive coverage of all of the entity's legal needs, including litigation with outside parties. Because both in-house and external legal counsel are bound by an applicable code of ethics, there should be no significant difference in their professional obligations and responsibilities. In some circumstances, external legal counsel, if used at all, may be used only for limited purposes, such as data accumulation or account collection activity. In such circumstances, in-house legal counsel may have the primary responsibility for corporate legal matters and may be in the best position to know and precisely describe the status of all litigation, claims, and assessments or to corroborate information provided by management.

Evaluation of the Outcome of Litigation, Claims, or Assessment (Ref: par. .22d(ii))

.A65 Although paragraph 5 of the ABA statement states that the legal counsel "may in appropriate circumstances communicate to the auditor his view that an unfavorable outcome is 'probable' or 'remote,'" the legal counsel is not required to use those terms in communicating the evaluation to the auditor. The auditor may find other wording sufficiently clear, as long as the terms can be used to classify the outcome of the uncertainty under one of the three probability classifications established in FASB ASC 450. Some examples of evaluations concerning litigation that may be considered to provide sufficient clarity that the likelihood of an unfavorable outcome is remote, even though they do not use that term, are the following:

- "We are of the opinion that this action will not result in any liability to the company."
- "It is our opinion that the possible liability to the company in this proceeding is nominal in amount."
- "We believe the company will be able to defend this action successfully."
- "We believe that the plaintiff's case against the company is without merit."
- "Based on the facts known to us, after a full investigation, it is our opinion that no liability will be established against the company in these suits."

Absent any contradictory information obtained by the auditor either in other parts of the legal counsel's letter or otherwise, the auditor need not obtain further clarification of evaluations such as the foregoing. Because of inherent uncertainties described in paragraph .A57 and the ABA statement, an evaluation furnished by the legal counsel may indicate significant uncertainties or stipulations about whether the client will prevail. The following are examples of the legal counsel's evaluations that are unclear about the likelihood of an unfavorable outcome:

- "This action involves unique characteristics wherein authoritative legal precedents do not seem to exist. We believe that the plaintiff will have serious problems establishing the company's liability under the act; nevertheless, if the plaintiff is successful, the award may be substantial."
- "It is our opinion that the company will be able to assert meritorious defenses to this action." (The term *meritorious defenses* indicates that the entity's defenses

will not be summarily dismissed by the court; it does not necessarily indicate the legal counsel's opinion that the entity will prevail.)

- "We believe the action can be settled for less than the damages claimed."
- "We are unable to express an opinion as to the merits of the litigation at this time. The company believes there is absolutely no merit to the litigation." (If the entity's legal counsel, with the benefit of all relevant information, is unable to conclude that the likelihood of an unfavorable outcome is remote, it is unlikely that management would be able to form a judgment to that effect.)
- "In our opinion, the company has a substantial chance of prevailing in this action." (A *substantial chance,* a *reasonable opportunity*, and similar terms indicate more uncertainty than an opinion that the company will prevail.)

If the auditor is uncertain about the meaning of the legal counsel's evaluation, clarification either in a follow-up letter or conference with the legal counsel and entity, appropriately documented, may be appropriate. If the legal counsel is still unable to give an unequivocal evaluation of the likelihood of an unfavorable outcome in writing or orally, the auditor is required by section 700 to determine the effect, if any, of the legal counsel's response on the auditor's report.

Segment Information (Ref: par. .25)

.A66 Depending on the applicable financial reporting framework, the entity may be required or permitted to disclose segment information in the financial statements. The auditor's responsibility regarding the presentation and disclosure of segment information is in relation to the financial statements as a whole. Accordingly, the auditor is not required to perform audit procedures that would be necessary to express an opinion on the segment information presented on a stand-alone basis.

Considerations Specific to Governmental Entities

.A67 For governmental entities required by the applicable financial reporting framework to disclose segment information, the auditor's responsibility regarding the presentation and disclosure of segment information is in relation to the financial statements of the opinion unit(s) on which the segment information is based. [fn 16]

Understanding of the Methods Used by Management (Ref: par. .25a)

.A68 Depending on the circumstances, examples of matters that may be relevant when obtaining an understanding of the methods used by management in determining segment

[fn 16] Paragraph .A14 of section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*.

information and evaluating whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework include the following:

- Sales, transfers, and charges between segments and elimination of intersegment amounts
- Comparisons with budgets and other expected results (for example, operating profits as a percentage of sales)
- The allocation of assets and costs among segments
- Consistency with prior periods and the adequacy of the disclosures with respect to inconsistencies
- Management's process for identifying those segments that require disclosure in accordance with the entity's financial reporting framework

Use of Management's Specialists (Ref: par. .26)

.A69 The preparation of an entity's financial statements may require expertise in a field other than accounting or auditing, such as actuarial calculations, valuations, or engineering data. The entity uses a management's specialist in these fields to obtain the needed expertise to prepare the financial statements. Failure to do so when such expertise is necessary increases the risks of material misstatement and may be a significant deficiency or material weakness. [fn 12]

.A70 When information to be used as audit evidence has been prepared using the work of a management's specialist, the requirement in paragraph 26 applies. For example, an individual or organization may possess expertise in the application of models to estimate the fair value of securities for which no observable market exists. If the individual or organization applies that expertise in making an estimate which the entity uses in preparing its financial statements, the individual or organization is a management's specialist and paragraph 26 applies. If, on the other hand, that individual or organization merely provides price data regarding private transactions not otherwise available to the entity which the entity uses in its own estimation methods, such information, if used as audit evidence, is subject to paragraph .07, but it is not the use of a management's specialist by the entity.

.A71 The nature, timing, and extent of audit procedures with regard to the requirement in paragraph 26 may be affected by such matters as the following:

fn 12 See section 265, *Communicating Internal Control Related Matters Identified in an Audit*, for further guidance.

- ***The nature and complexity of the matter to which the management's specialist relates***
- ***The risks of material misstatement of the matter***
- ***The availability of alternative sources of audit evidence***
- ***The nature, scope, and objectives of the work of the management's specialist***
- ***Whether the management's specialist is employed by the entity or is a party engaged by it to provide relevant services***
- ***The extent to which management can exercise control or influence over the work of the management's specialist***
- ***Whether the management's specialist is subject to technical performance standards or other professional or industry requirements***
- ***The nature and extent of any controls within the entity over the work of the management's specialist***
- ***The auditor's knowledge and experience of the field of expertise management's specialist***
- ***The auditor's previous experience of the work of that specialist***

The Competence, Capabilities, and Objectivity of a Management's Specialist (Ref: par. .26a)

.A72 Competence relates to the nature and level of expertise of the management's specialist. Capability relates to the ability of the management's specialist to exercise that competence in the circumstances. Factors that influence capability may include, for example, geographic location and the availability of time and resources. Objectivity relates to the possible effects that bias, conflict of interest, or the influence of others may have on the professional or business judgment of the management's specialist. The competence, capabilities, and objectivity of a management's specialist, and any controls within the entity over that specialist's work, are important factors with regard to the reliability of any information produced by a management's specialist.

.A73 Information regarding the competence, capabilities, and objectivity of a management's specialist may come from a variety of sources, such as the following:

- ***Personal experience with previous work of that specialist***
- ***Discussions with that specialist***
- ***Discussions with others who are familiar with that specialist's work***

- ***Knowledge of that specialist's qualifications, membership in a professional body or industry association, license to practice, or other forms of external recognition***

- ***Published papers or books written by that specialist***

- ***An auditor's specialist, if any, that assists the auditor in obtaining sufficient appropriate audit evidence with respect to information produced by the management's specialist***

.A74 Matters relevant to evaluating the competence, capabilities, and objectivity of a management's specialist include whether that specialist's work is subject to technical performance standards or other professional or industry requirements, for example, ethical standards and other membership requirements of a professional body or industry association, accreditation standards of a licensing body, or requirements imposed by law or regulation.

.A75 Other matters that may be relevant include

- ***the relevance of the capabilities and competence of the management's specialist to the matter for which that specialist's work will be used, including any areas of specialty within that specialist's field. For example, a particular actuary may specialize in property and casualty insurance but have limited expertise regarding pension calculations.***

- ***the competence of the management's specialist with respect to relevant accounting requirements, for example, knowledge of assumptions and methods, including models, when applicable, that are consistent with the applicable financial reporting framework.***

- ***whether unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures indicate that it may be necessary to reconsider the initial evaluation of the competence, capabilities, and objectivity of the management's specialist as the audit progresses.***

.A76 A broad range of circumstances may threaten objectivity, for example, self-interest threats, advocacy threats, familiarity threats, self-review threats, and intimidation threats. Safeguards may reduce such threats and may be created either by external structures (for example, the profession, legislation, or regulation of the management's specialist) or by the work of the management's specialist environment (for example, quality control policies and procedures).

.A77 Although safeguards cannot eliminate all threats to the objectivity of a management's specialist, threats such as intimidation threats may be of less significance to a specialist engaged by the entity than to a specialist employed by the entity, and the effectiveness of safeguards such as quality control policies and procedures may be greater. Because the threat to objectivity created by being an employee of the entity will always be

present, a specialist employed by the entity cannot ordinarily be regarded as being more likely to be objective than other employees of the entity.

.A78 When evaluating the objectivity of a specialist engaged by the entity, it may be relevant to discuss with management and that specialist any interests and relationships that may create threats to the specialist's objectivity and any applicable safeguards, including any professional requirements that apply to the specialist, and to evaluate whether the safeguards are adequate. Interests and relationships creating threats may include the following:

- ***Financial interests***
- ***Business and personal relationships***
- ***Provision of other services***

Obtaining an Understanding of the Work of the Management's Specialist (Ref: par. .26b)

.A79 An understanding of the work of the management's specialist includes an understanding of the relevant field of expertise. An understanding of the relevant field of expertise may be obtained in conjunction with the auditor's determination of whether the auditor has the expertise to evaluate the work of the management's specialist, or whether the auditor needs an auditor's specialist for this purpose. [fn 13]

.A80 Aspects of the field of the management's specialist relevant to the auditor's understanding may include

- ***whether that specialist's field has areas of specialty within it that are relevant to the audit.***
- ***whether any professional or other standards and regulatory or legal requirements apply.***
- ***what assumptions and methods are used by the management's specialist and whether they are generally accepted within that specialist's field and appropriate for financial reporting purposes.***
- ***the nature of internal and external data or information the management's specialist uses.***

.A81 In the case of a management's specialist engaged by the entity, there will ordinarily be an engagement letter or other written form of agreement between the entity and that specialist. Evaluating that agreement when obtaining an understanding of the work of the

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fn 13 Paragraph .07 of section 620, *Using the Work of an Auditor's Specialist*.

management's specialist may assist the auditor in determining for the auditor's purposes the appropriateness of

- ***the nature, scope, and objectives of that specialist's work;***
- ***the respective roles and responsibilities of management and that specialist; and***
- ***the nature, timing, and extent of communication between management and that specialist, including the form of any report to be provided by that specialist.***

.A82 In the case of a management's specialist employed by the entity, it is less likely that there will be a written agreement of this kind. Inquiry of the specialist and other members of management may be the most appropriate way for the auditor to obtain the necessary understanding.

Evaluating the Appropriateness of the Work of the Management's Specialist (Ref: par. .26c)

.A83 Considerations when evaluating the appropriateness of the work of the management's specialist as audit evidence for the relevant assertion may include

- ***the relevance and reasonableness of that specialist's findings or conclusions, their consistency with other audit evidence, and whether they have been appropriately reflected in the financial statements;***
- ***if that specialist's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods; and***
- ***if that specialist's work involves significant use of source data, the relevance, completeness, and accuracy of that source data.***