



***Statement on
Auditing Standards***

*June 2021
144*

Issued by the Auditing Standards Board

**Amendments to AU-C Sections 501, 540, and 620 Related to the Use
of Specialists and the Use of Pricing Information
Obtained From External Information Sources**

(Amends Statements on Auditing Standards)

- ***No. 122, Statements on Auditing Standards: Clarification and Recodification, as amended***
 - ***Section 501, Audit Evidence — Specific Considerations for Selected Items [AICPA, Professional Standards, AU-C sec. 501]***
 - ***Section 620, Using the Work of an Auditor’s Specialist [AICPA, Professional Standards, AU-C sec. 620]***
- ***No. 143, Auditing Accounting Estimates and Related Disclosures [AICPA, Professional Standards, AU-C sec. 540]***

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(2020–2021)**

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¹ All ET sections can be found in AICPA *Professional Standards*.

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Amendment to AU-C Section 501, *Audit Evidence — Specific Considerations for Selected Items*

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

NOTE

The amendments in this Statement on Auditing Standards (SAS) to AU-C section 501 are presented in the context of AU-C section 501 in its entirety, as amended by SAS Nos. 142, *Audit Evidence*, and 143, *Auditing Accounting Estimates and Related Disclosures*, which become effective for audits of financial statements for periods ending on or after December 15, 2022 and 2023, respectively. Each paragraph and footnote in this section that has been amended by SAS Nos. 142 and 143 contains a bracketed sentence denoting the amendment. In addition, this SAS includes bracketed italicized sentences to indicate paragraphs that have not been amended by this SAS.

1. AU-C section 501, *Audit Evidence — Special Considerations for Selected Items*, addresses specific considerations by the auditor, in obtaining sufficient appropriate audit evidence, regarding aspects of selected items, including use of management’s specialists. This amendment adds application material from appendix A, “Using the Work of a Company’s Specialist as Audit Evidence,” of AS 1105, *Audit Evidence*, that the ASB believes will enhance the quality of audits of financial statements of nonissuers. The additional application material provides guidance on applying AU-C section 500, *Audit Evidence*, when management has used the work of a specialist in making accounting estimates. AU-C section 501 is also amended to no longer refer to using the work of an external inventory-taking firm as using the work of a management’s specialist.
2. This amendment is effective for audits of financial statements for periods ending on or after December 15, 2023.

[No amendment to paragraphs .01–.02, shown below for context.]

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 500A, *Audit Evidence*; section 540, *Auditing Accounting Estimates and Related Disclosures*; 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; (d) segment information in an audit of financial statements; and (e) use of management’s specialists.

[As amended, effective for audits of financial statements for periods ending on or after December 15, 2022, by SAS No. 142. As amended, effective for audits of financial statements for periods ending on or after December 15, 2023, by SAS No. 143.]

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;
- d. presentation and disclosure of segment information, in accordance with the applicable financial reporting framework; and
- e. ~~use~~ *work* of management's specialists.

[As amended, effective for audits of financial statements for periods ending on or after December 15, 2022, by SAS No. 142.]

[No amendment to paragraphs .04–.25, shown below for context.]

Definition

.04 For purposes of GAAS, the following term has the meaning 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.

[Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 2022, by SAS No. 142.]

Requirements

Investments in Securities and Derivative Instruments (Ref: par. .A1–.A4)

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

.05 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 audit evidence regarding the investee's financial results, including as applicable in the circumstances, performing the following procedures: (Ref: par. .A5–.A9)

- 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 regarding 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. .A10)

If the auditor is not able to obtain sufficient appropriate audit evidence in support of the investee's financial results because of an inability to perform appropriate 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*. [Paragraph renumbered and amended, effective for audits of financial statements for periods ending on or after December 15, 2023, by SAS No. 143.]

.06 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. .A11) [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

[.07–.11] [Paragraphs renumbered and deleted by the issuance of SAS No. 143, July 2020.] ^[fn 1]

^[fn 1] [Footnote deleted by the issuance of SAS No. 143, July 2020.]

Inventory

.12 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. .A21–.A23)
 - i. evaluate management’s instructions and procedures for recording and controlling the results of the entity’s physical inventory counting, (Ref: par. .A24)
 - ii. observe the performance of management’s count procedures, (Ref: par. .A25)
 - iii. inspect the inventory, and (Ref: par. .A26)
 - iv. perform test counts and (Ref: par. .A27)
- b. performing audit procedures over the entity’s final inventory records to determine whether they accurately reflect actual inventory count results. (Ref: par. .A28–.A31)

[Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

.13 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 .12, 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. .A32–.A34)

[Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

.14 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. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

.15 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 modify the opinion in the auditor’s report, in accordance with section 705. (Ref: par. .A35–.A37) [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

^{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.

.16 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. .A38)
- b. Perform inspection or other audit procedures appropriate in the circumstances (Ref: par. .A39)

[Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

Litigation, Claims, and Assessments

.17 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. .A40–.A46)

- 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.

[Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

.18 For actual or potential litigation, claims, and assessments identified based on the audit procedures required in paragraph .17, 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

[Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

Communication With the Entity's Legal Counsel

.19 Unless the audit procedures required by paragraph .17 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. .A41 and .A47–.A64) [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

.20 In addition to the direct communications with the entity's external legal counsel referred to in paragraph .19, 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 .19. 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 .19. (Ref: par. .A65) [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

.21 The auditor should document the basis for any determination not to seek direct communication with the entity's legal counsel, as required by paragraphs .19–.20. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

.22 The auditor should request management to authorize the entity's legal counsel to discuss applicable matters with the auditor. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

.23 As described in paragraphs .19–.20, 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. .A85)

- 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. .A66)
 - 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

[Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

.24 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. .A56) [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

.25 The auditor should modify the opinion in the auditor's report, in accordance with section 705, if (Ref: par. .A57–.A66)

- 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.

[Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

Segment Information

.26 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. .A67–.A68)

- a. obtaining an understanding of the methods used by management in determining segment information and (Ref: par. .A69)
 - 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.

[Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

Use of Management's ~~Specialists~~ *Specialist*

.27 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, ***perform the following***: (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 (Ref: par. .A79–.A82)
- c. ***Evaluate*** the appropriateness of that specialist's work as audit evidence for the relevant assertion (Ref: par. .A83–.A88)

[Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 2022, by SAS No. 142. Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

[No amendment to paragraphs .A1–.A28, shown below for context.]

Application and Other Explanatory Material

Investments in Securities and Derivative Instruments (Ref: par. .05–.06)

.A1 Section 540, *Auditing 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. This section addresses aspects relating to auditing valuation of investments in securities and derivative instruments that are incremental to section 540. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 2023, by SAS No. 143.]

.A2 Evaluating audit evidence for assertions about investments in securities and derivative instruments often involves 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 relating to investments in securities and derivative instruments 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 may be 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. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

.A3 This section addresses only certain specific aspects relating to auditing valuation of investments in securities and derivative instruments. Section 540A, *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. [Paragraph renumbered and amended, effective for audits of financial statements for periods ending on or after December 15, 2023, by SAS No. 143.]

Investments in Securities When Valuations Are Based on Cost

.A4 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. Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

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. .05–.06)

.A5 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. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

.A6 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 of the amount used in the estimate. 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. [Paragraph renumbered and amended, effective for audits of financial statements for periods ending on or after December 15, 2023, by SAS No. 143.]

.A7 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, when the date of the audited financial statements is different from the investor's measurement date. Further examples for when the auditor may conclude that additional audit evidence is needed include 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. [Paragraph renumbered and amended, effective for audits of financial statements for periods ending on or after December 15, 2023, by SAS No. 143.]

.A8 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.

[Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

.A9 Section 540, *Auditing Accounting Estimates and Related Disclosures*, addresses auditing fair value accounting estimates. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

.A10 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 .05d, 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. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

.A11 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. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

[.A12–.A20] [Paragraphs renumbered and deleted by the issuance of SAS No. 143, July 2020.]
[fns 4–6]

Inventory

Attendance at Physical Inventory Counting (Ref: par. .12a)

.A21 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. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

.A22 Attendance at physical inventory counting involves

- inspecting the inventory to ascertain its existence and evaluate its condition and performing test counts,

[fns 4–6] [Footnotes deleted by the issuance of SAS No. 143, July 2020.]

- 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. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

.A23 Matters relevant in planning attendance at physical inventory counting (or in designing and performing audit procedures pursuant to paragraphs .12–.16) 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.

[Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

Evaluate Management’s Instructions and Procedures (Ref: par. .12a(i))

.A24 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

[Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

Observe the Performance of Management's Count Procedures (Ref: par. .12a(ii))

.A25 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. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

Inspect the Inventory (Ref: par. .12a(iii))

.A26 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. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

Perform Test Counts (Ref: par. .12a(iv))

.A27 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. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

.A28 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. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

*Use ~~Using the Work of Management's Specialists~~ **an External Inventory-Taking Firm***

.A29 Management may engage ~~specialists~~ **external organizations that** ~~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, **such external inventory-taking firms are often used by** entities such as retail stores, hospitals, and automobile dealers ~~may use specialists in this manner.~~

~~.A30 An inventory count performed by *The report of* an external inventory-taking firm engaged as a management specialist *about the work it performed* does not, by itself, provide the auditor with sufficient appropriate audit evidence. *Paragraph .12* The auditor is required by section 500 *requires the auditor, if inventory is material to the financial statements*, to perform certain procedures if information to be used as audit evidence has been prepared using the work of a management's specialist *regarding the existence and condition of inventory*.^{fn7} The auditor may, for example, examine the specialist's *external inventory-taking firm'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.~~

~~^{fn7} Paragraph .08 of section 500 addresses management's specialists.~~

.A31 Although the auditor may adjust the extent of the work on the physical count of inventory because of the work of management's specialist *an external inventory-taking firm*, 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. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

[No amendment to paragraphs .A32–.A70, shown below for context.]

Physical Inventory Counting Conducted Other Than at the Date of the Financial Statements (Ref: par. .13)

.A32 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} [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

.A33 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. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

^{fn 7} [Footnote deleted.]

^{fn 8} Paragraphs .23–.24 of section 330.

.A34 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

[Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

Attendance at Physical Inventory Counting Is Impracticable (Ref: par. .15)

.A35 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. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

.A36 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. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

.A37 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} [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

Inventory Under the Custody and Control of a Third Party

Confirmation (Ref: par. .16a)

.A38 Section 505, *External Confirmations*, addresses external confirmation procedures. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

Other Audit Procedures (Ref: par. .16b)

.A39 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

[Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

Litigation, Claims, and Assessments

Completeness of Litigation, Claims, and Assessments (Ref: par. .17)

.A40 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. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

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

.A41 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

- 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.

[Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

.A42 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. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

.A43 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 .17a, 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}

[Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

.A44 In addition to the procedures identified in paragraph .17, 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

^{fn 10} Paragraph .15 of section 580, *Written Representations*.

become aware of litigation, claims, and assessments involving the entity. Examples of such procedures are as follows:

- 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. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

.A45 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. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

.A46 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 .17 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. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

Communication With the Entity's Legal Counsel (Ref: par. .19–.25)

.A47 An auditor ordinarily does not possess legal skills and, therefore, cannot make legal judgments concerning information coming to the auditor's attention. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

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

- .A48** 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. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]
- .A49** 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} [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]
- .A50** 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. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]
- .A51** 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. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

- .A52** An external legal counsel’s response to a letter of inquiry and the procedures set forth in paragraphs .17–.18 provide the auditor with sufficient appropriate audit evidence concerning the accounting for, and reporting of, pending and threatened litigation, claims, and assessments. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]
- .A53** 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

^{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.

updated information from the entity's legal counsel. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

- .A54** In accordance with section 700, *Forming an Opinion and Reporting on Financial Statements*, or section 703, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA*, 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 auditor's opinion on the financial statements.^{fn13} 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. [As amended, effective for audits of financial statements for periods ending on or after December 15, 2021, by SAS No. 136. Paragraph renumbered by the issuance of SAS No. 143, July 2020.]
- .A55** 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. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]
- .A56** 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. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]
- .A57** 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. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]
- .A58** 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

^{fn 13} Paragraph .43 of section 700, *Forming an Opinion and Reporting on Financial Statements*, or paragraphs .82 and .126 of section 703, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA*. [As amended, effective for audits of financial statements for periods ending on or after December 15, 2021, by SAS No. 136.]

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 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} [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

- .A59** 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. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]
- .A60** 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. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]
- .A61** 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} [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]
- .A62** 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.

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

^{fn 15} Paragraph .13 of section 705.

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 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." [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

- .A63** 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. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

- .A64** 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. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

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

.A65 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. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

Evaluation of the Outcome of Litigation, Claims, or Assessment (Ref: par. .23d(ii))

.A66 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 .A58 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, or section 703, to determine the effect, if any, of the legal counsel's response on the auditor's report. [As amended, effective for audits of financial statements for periods ending on or after December 15, 2021, by SAS No. 136. Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

Segment Information (Ref: par. .26)

- .A67** 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. [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

Considerations Specific to Governmental Entities

.A68 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} [Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

Understanding of the Methods Used by Management (Ref: par. .26a)

.A69 Depending on the circumstances, examples of matters that may be relevant when obtaining an understanding of the methods used by management in determining segment 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

[Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

Use of the Work of a Management’s Specialist (Ref: par. .27)

.A70 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 17} [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 2022, by SAS No. 142. Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

^{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*.

^{fn 17} See section 265, *Communicating Internal Control Related Matters Identified in an Audit*, for further guidance. [Footnote added, effective for audits of financial statements for periods ending on or after December 15, 2022, by SAS No. 142.]

.A71 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 *the evaluation required by AU-C section 500*,^{fn 18} but it is not the use of a management’s specialist by the entity.

^{fn 18} See paragraph .07 of AU-C section 500, **Audit Evidence**.

.A72 The nature, timing, and extent of audit procedures with regard to the requirement in paragraph .27 may be affected by ~~such~~ matters *such* as the following:

- 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 *management’s specialist (including, when applicable, the organization that employs the individual specialist), thereby influencing 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 of management’s specialist
- The auditor’s previous experience of the work of that specialist

More persuasive audit evidence is needed with regard to the requirement in paragraph .27 as the significance of the management’s specialist’s work, the risk of material misstatement at the relevant assertion level, or the ability of management to affect the specialist’s judgments increases, or as the competence, capabilities, and objectivity possessed by the specialist in the particular field decreases. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 2022, by SAS No. 142. Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

[No amendment to paragraphs .A73–.A78, shown below for context.]

The Competence, Capabilities, and Objectivity of a Management’s Specialist (Ref: par. 27a)

.A73 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. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 2022, by SAS No. 142. Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

.A74 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

[Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 2022, by SAS No. 142. Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

.A75 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. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 2022, by SAS No. 142. Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

.A76 Other matters that may be relevant include the following:

- 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.

[Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 2022, by SAS No. 142. Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

.A77 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’s environment (for example, quality control policies and procedures). [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 2022, by SAS No. 142. Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

.A78 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. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 2022, by SAS No. 142. Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

.A79 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. ***Relevant information may be obtained by the auditor from procedures performed in accordance with AU-C section 550, Related Parties.*** Interests and relationships creating threats may include the following:

- Financial interests
- Business and personal relationships ***between the entity and the individual specialist and between the entity and the organization that employs the individual specialist***
- Provision of other services

[Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 2022, by SAS No. 142. Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

[No amendment to paragraph .A80, shown below for context.]

Obtaining an Understanding of the Work of the Management’s Specialist (Ref: par. .27b)

.A80 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 18} [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 2022, by SAS No. 142. Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

.A81 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~~ ***appropriately applied under the applicable financial reporting framework.*** ~~for financial reporting purposes.~~
- the nature of internal and external data or information the management’s specialist uses.

[Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 2022, by SAS No. 142. Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

[No amendment to paragraphs .A82–.A83, shown below for context.]

.A82 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 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.

[Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 2022, by SAS No. 142. Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

.A83 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

^{fn 18} Paragraph .07 of section 620, *Using the Work of an Auditor’s Specialist*. [Footnote added, effective for audits of financial statements for periods ending on or after December 15, 2022, by SAS No. 142.]

management may be the most appropriate way for the auditor to obtain the necessary understanding. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 2022, by SAS No. 142. Paragraph renumbered by the issuance of SAS No. 143, July 2020.]

Evaluating the Appropriateness of the Work of the Management's Specialist (Ref: par. .27c)

.A84 AU-C section 540, Auditing Accounting Estimates and Related Disclosures, includes requirements and guidance related to accounting estimates, including the selection and application of the methods, significant assumptions, and data used in making the accounting estimate.^{fn 19} 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 significant assumptions, *the appropriateness of the assumptions, taking into account the consistency of those assumptions with relevant information* and methods, the relevance and reasonableness of those assumptions and methods; and**
- ***if that specialist's work involves the use of methods, the appropriateness of the methods under the circumstances, taking into account the requirements of the applicable financial reporting framework;***
- **if that specialist's work involves significant use of source data, *including entity-produced data*, the relevance, completeness, and accuracy *reliability* of that source data; and**
- ***the relevance and reasonableness of that specialist's findings or conclusions, the consistency of the findings or conclusions with other audit evidence, and whether the findings or conclusions have been appropriately reflected in the financial statements.***

^{fn 19} Paragraph .21 of section 540.

.A85 If the work of the management's specialist involves use of significant assumptions developed by the management's specialist, evaluating the appropriateness of those assumptions may include taking into account the consistency of those assumptions with relevant information such as the following:

- ***Assumptions generally accepted within the specialist's field***
- ***Supporting information provided by the specialist***
- ***Industry, regulatory, and other external factors, including economic conditions***
- ***The entity's objectives, strategies, and related business risks***
- ***Existing market information***
- ***Historical or recent experience, along with changes in conditions and events affecting the entity***

- *Significant assumptions used in other estimates tested in the entity's financial statements*

.A86 If the methods of the management's specialist include the use of a proprietary model, the auditor's procedures may include, for example

- *obtaining an understanding of the model through*
 - *inquiry of the specialist, and*
 - *reading descriptions of the model in the specialist's report or equivalent communication;*
- *testing controls over the entity's evaluation of the specialist's work;*
- *testing mathematical accuracy of the calculations under the model, if practicable; or*
- *assessing the inputs to and output from the model, which may involve using an alternative model for comparison.*

The extent of such procedures will depend on the type of model used (for example, commercially available versus internally developed) and the applicability of the factors described in paragraph .A71.

.A87 Factors that affect the relevance and reliability of the work of the management's specialist include the following:

- *The results of the auditor's procedures over internal or external data, significant assumptions, and methods*
- *The nature of any restrictions, disclaimers, or limitations in the specialist's report or equivalent communication*
- *The consistency of the management's specialist's work with other evidence obtained by the auditor and the auditor's understanding of the entity and its environment*

.A88 Additional procedures may be necessary if the management's specialist's findings or conclusions appear to contradict the relevant assertion, or the management's specialist's work does not provide sufficient appropriate audit evidence. Examples of situations in which additional procedures may be necessary include the following:

- *The findings and conclusions of the management's specialist are inconsistent with*
 - *other information, if any, in the specialist's report, or equivalent communication,*
 - *other evidence obtained by the auditor, or*
 - *the auditor's understanding of the entity and its environment.*
- *The management's specialist's report, or equivalent communication, contains restrictions, disclaimers, or limitations regarding the auditor's use of the report or communication.*

- *The auditor has identified exceptions in performing procedures related to data, significant assumptions, or methods.*
- *The auditor has doubts about the competence, capabilities, or objectivity of the management's specialist.*
- *The management's specialist has a conflict of interest relevant to the specialist's work.*

[No amendment to paragraphs .A85–.A87, which are renumbered as paragraphs .A89–.A92. No further amendment to AU-C section 501.]

Amendment to AU-C Section 540, *Auditing Accounting Estimates and Related Disclosures*

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

3. AU-C section 540, *Auditing Accounting Estimates and Related Disclosures*, addresses the auditor’s responsibilities relating to auditing accounting estimates and related disclosures. It expands on how AU-C section 500, *Audit Evidence*, and other relevant AU-C sections are to be applied with regard to accounting estimates and related disclosures. AU-C section 500 requires the auditor to take into account the relevance and reliability of information to be used as audit evidence, including its source, and contains an appendix addressing the use of external information sources. This amendment to AU-C section 540 adds a new appendix, “Use of Pricing Information From Third Parties as Audit Evidence,” that provides guidance on the use of pricing information obtained from external information sources to be used as audit evidence for estimates related to the fair value of financial instruments. This appendix takes into account PCAOB AS 2501, Appendix A, “Special Topics, Identifying and Assessing Risks of Material Misstatement Related to the Fair Value of Financial Instruments”

4. This amendment is effective for audits of financial statements for periods ending on or after December 15, 2023.

[Footnote text not amended is omitted for purposes of this amendment. No amendment to paragraphs .01–A106.]

.A107 AU-C section 500 requires the auditor to evaluate information to be used as audit evidence by taking into account, among other things, the relevance and reliability of the information, including its source. The auditor’s evaluation of such information to be used as audit evidence is required to include evaluating whether the information is sufficiently precise and detailed for the auditor’s purposes and obtaining audit evidence about the accuracy and completeness of the information, as necessary. ***Paragraphs .A126–A129 provide further guidance related to evaluating information from external information sources.***

[No amendment to paragraphs .A108–A126.]

.A127 As explained in AU-C section 500, the reliability of evidence depends on the nature and source of the audit evidence and the circumstances under which it is obtained. Generally, the reliability of audit evidence increases when it is obtained from external parties because the information is less susceptible to management bias.⁵³ Consequently, the nature and extent of the auditor’s further audit procedures to consider the reliability of the information used in making an accounting estimate may vary depending on the nature of these factors. Examples follow:

- When market or industry data, ~~prices, or pricing-related data are~~ ***is*** obtained from a single external information source specializing in such information, the auditor may seek ~~a price~~ ***data*** from an alternative independent source with which to compare.

- When market or industry data, prices, or pricing-related data are obtained from multiple independent external information sources and points to consensus across those sources, the auditor may need to obtain less evidence about the reliability of the data from an individual source.
- When information obtained from multiple information sources points to divergent market views, the auditor may seek to understand the reasons for the diversity in views. The diversity may result from the use of different methods, assumptions, or data. For example, one source may be using current prices, and another may be using future prices. When the diversity relates to estimation uncertainty, the auditor is required by paragraph .26b of this SAS to obtain sufficient appropriate audit evidence about whether, in the context of the applicable financial reporting framework, the disclosures in the financial statements that describe the estimation uncertainty are reasonable. In such cases, professional judgment is also important in considering information about the methods, assumptions, or data applied.
- When information obtained from an external information source has been developed by that source using its own models (for example, for a derivative instrument or security, a pricing model or cash flow projection model), SAS No. 142, *Audit Evidence*,⁵⁴ provides relevant guidance for the auditor.
- When, for derivative instruments or securities, a 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 auditor may determine that it is necessary to obtain estimates from more than one pricing source.

.A128 For fair value accounting estimates, additional considerations of the relevance and reliability of information obtained from external information sources may include the following:

- a. Whether fair values are based on trades of the same instrument or active market quotations
- b. When the fair values are based on transactions of comparable assets or liabilities, how those transactions are identified and considered comparable
- c. When there are no transactions either for the asset or liability or comparable assets or liabilities, how the information was developed, including whether the inputs developed and used represent the assumptions that market participants would use when pricing the asset or liability, if applicable
- ~~d. When the fair value measurement is based on a broker quote, whether the broker quote

 - ~~i. is from a market maker who transacts in the same type of financial instrument,~~
 - ~~ii. is binding or nonbinding, with more weight placed on quotes based on binding offers, and~~~~

⁵⁴ Appendix A, “Considerations Regarding the Use of External Information Sources,” of SAS No. 142, *Audit Evidence*.

iii. ~~reflects market conditions as of the date of the financial statements, when required by the applicable financial reporting framework.~~

Examples of sources relating to (a) and (b) for derivative instruments and securities listed on national exchanges or over-the-counter (OTC) markets include financial publications, the exchanges, NASDAQ, or pricing services based on sources such as those. For derivative instruments and securities, if quoted market prices are not available, estimates of fair value frequently may be obtained from, for example, 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). Examples of broker quotes for certain derivative instruments and securities include quoted market prices obtained from broker-dealers who are market makers in such derivative instruments and securities or through electronic quotation and trading systems for OTC securities. However, using such a price quote to test valuation assertions may require special knowledge to understand the circumstances in which the quote was developed. For example, quotations published by electronic quotation and trading systems for OTC securities 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. *Appendix C, “Use of Pricing Information From Third Parties as Audit Evidence,” provides further guidance on the use of pricing information from third parties, including brokers or dealers, as audit evidence.*

[No amendment to paragraphs .A129–.A153. The amendment to paragraph .A154, appendix C, changes the title and inserts new content.]

~~.A154 Appendix C — Amendments to Various Sections in SAS No. 122, Statements on Auditing Standards: Clarification and Recodification, as Amended; SAS No. 134, Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements, as Amended; and SAS No. 136, Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA, as Amended~~ **Use of Pricing Information From Third Parties as Audit Evidence**

1. *AU-C section 500, Audit Evidence, contains requirements and provides guidance about evaluating information to be used as audit evidence, including information from external information sources. AU-C section 540 provides guidance on complying with AU-C section 500 with respect to information to be used as audit evidence relating to accounting estimates, without regard to the sources of information. As explained in AU-C section 500, the reliability of evidence depends on the nature and source of the audit evidence and the circumstances under which it is obtained. Generally, the reliability of audit evidence increases when it is obtained from external parties because the information is less susceptible to management bias. This appendix provides additional guidance about information used as audit evidence for estimates, when that information is pricing information obtained from external information sources.*

2. *When the auditor uses pricing information from an external information source to develop an independent expectation or evaluates pricing information provided by a third party used by the entity, the requirement in section 500¹ to evaluate information to be used as audit evidence applies. Quoted market prices for derivative instruments and securities listed on national exchanges or OTC markets that are obtained from sources such as financial publications, the exchanges, NASDAQ, or pricing services based on sources such as these generally provide sufficient evidence of the fair value of the derivative instruments and securities. The following paragraphs provide guidance for evaluating pricing information from the following sources:*
 - a. *Organizations that routinely provide uniform pricing information to users, generally on a subscription basis (pricing services). Note that when a pricing service is engaged to individually develop a price for a specific financial instrument not routinely priced for its subscribers, the requirements in sections 501 and 620 relating to management's or the auditor's specialist, respectively, apply.*
 - b. *Brokers or dealers.*

¹ Paragraph .07 of AU-C section 500, Audit Evidence.

Using Pricing Information From Pricing Services

3. *Appendix A, "Considerations Regarding the Use of External Information Sources," of section 500 provides guidance relevant to evaluating the reliability of information from external information sources. The reliability of information to be used as audit evidence depends on the nature and source of the information and the circumstances under which it is obtained. The following factors affect the reliability of pricing information provided by a pricing service:*
 - a. *The experience and expertise of the pricing service relative to the types of financial instruments being valued, including whether the types of financial instruments being valued are routinely priced by the pricing service*
 - b. *Whether the methodology used by the pricing service in determining fair value of the types of financial instruments being valued is in accordance with the applicable financial reporting framework*
 - c. *Whether the pricing service has a relationship with the entity by which management has the ability to influence the pricing service*
4. *The procedures performed under section 550, Related Parties, can assist the auditor in evaluating the reliability of the audit evidence obtained from the pricing service by taking into account the ability of management to influence the information obtained from the pricing service through relationships between the entity and the pricing service. The existence of a process by which subscribers can challenge a pricing service's pricing information does not, by itself, mean that management has the ability to influence that pricing service.*

5. *If the auditor performs procedures to assess the reliability of pricing information provided by a pricing service at an interim date, the auditor may determine it necessary to evaluate whether the pricing service has changed its valuation process relative to the types of financial instruments being valued and, if so, the effect of such changes on the pricing information provided at period end.*
6. *The relevance of audit evidence refers to its relationship to the assertion or to the objective of the control being tested. The following factors affect the relevance of pricing information provided by a pricing service:*
 - a. *Whether the fair values are based on quoted prices in active markets for identical financial instruments*
 - b. *When the fair values are based on transactions of similar financial instruments, how those transactions are identified and considered comparable to the financial instruments being valued*
 - c. *When no recent transactions have occurred for either the financial instrument being valued or similar financial instruments or the price was developed using a nonbinding quote from a broker or dealer, how the fair value was developed, including whether the inputs used represent the assumptions that market participants would use when pricing the financial instruments*
7. *Fair values of financial instruments based on trades of identical financial instruments in an active market have a lower risk of material misstatement than fair values derived from observable trades of similar financial instruments or unobservable inputs. When the fair values are based on transactions of similar financial instruments, audit procedures to evaluate the process used by the pricing service may include evaluating how transactions are identified, considered comparable, and used to value the types of financial instruments selected for testing.*
8. *When financial instruments are similar, and are priced by the pricing service using the same process, procedures related to the information from the pricing service may be performed for financial instruments as a group, rather than for each instrument individually. Considerations for determining the similarity of the financial instruments include the following matters:*
 - *The terms and characteristics of the financial instruments*
 - *The extent to which the fair value of the type of financial instrument is based on inputs that are observable directly or indirectly*
 - *Other factors affecting the valuation of the financial instruments, such as credit or counterparty risk, market risk, and liquidity risk*
9. *When no recent transactions have occurred for either the financial instrument being valued or similar financial instruments, audit procedures may include evaluating the appropriateness of the valuation method and the reasonableness of observable and unobservable inputs used by the pricing service.*

Using Pricing Information From Multiple Pricing Services

10. *When pricing information is obtained from multiple pricing services (that is, more than one), less information may be needed about the particular methods and inputs used by the individual pricing services based on the presence of factors such as the following:*
- a. *There are recent trades of the financial instrument or of financial instruments substantially similar to the financial instruments being valued.*
 - b. *The type of financial instrument being valued is routinely priced by several (that is, more than two) pricing services.*
 - c. *Prices obtained are reasonably consistent across pricing services, taking into account the nature and characteristics of the financial instruments being valued, and market conditions.*
 - d. *The pricing information for the type of financial instrument is generally based on inputs that are observable.*
11. *When one or more of the preceding factors are not present, further audit procedures may be necessary to evaluate the appropriateness of the valuation method and the reasonableness of observable and unobservable inputs for a representative price for the type of financial instrument being valued.*

Using Pricing Information From a Broker or Dealer

12. *When a fair value measurement is based on a quote from a broker or dealer (broker quote), the relevance and reliability of the evidence provided by the broker quote depend on whether*
- a. *the broker or dealer has a relationship with the entity by which management has the ability to influence the broker or dealer;*
 - b. *the broker or dealer making the quote is a market maker that transacts in the same type of financial instrument;*
 - c. *the broker quote reflects market conditions as of the date of the financial statements;*
 - d. *the broker quote is binding on the broker or dealer; and*
 - e. *there are any restrictions, limitations, or disclaimers in the broker quote and, if so, their nature.*
13. *Broker quotes generally provide more relevant and reliable evidence when they are timely, binding quotes, without any restrictions, limitations, or disclaimers, from unaffiliated market makers transacting in the same type of financial instrument. If the broker quote does not provide sufficient appropriate audit evidence, additional procedures the auditor may perform include obtaining relevant and reliable pricing information from another pricing source.*
14. *The procedures performed under section 550, Related Parties, can assist the auditor in evaluating the reliability of the audit evidence obtained from the broker or dealer by taking*

into account the ability of management to influence the information obtained from the broker or dealer through relationships between the entity and the broker or dealer.

Unobservable Inputs

15. When the valuation of a financial instrument includes unobservable inputs that are significant to the valuation, obtaining an understanding of how unobservable inputs were determined and evaluating the reasonableness of the unobservable inputs may include taking into account the following:

- a. Whether modifications made to observable information generally reflect the assumptions that market participants would use when pricing the financial instrument, including assumptions about risk*
- b. How management determined its fair value measurement, including whether it appropriately considered the information available*

[Existing paragraph .A154 is renumbered as .A155 and relabeled as appendix D. No further amendment to AU-C section 540.]

Amendment to AU-C Section 620, *Using the Work of an Auditor's Specialist*

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

5. AU-C section 620, *Related Parties*, addresses the auditor's responsibility relating to using the work of an auditor's specialist. This amendment adds material from PCAOB Release No. 2018-006, *Amendments to Auditing Standards for Auditor's Use of the Work of Specialists* that the ASB believes will enhance the quality of audits of financial statements of nonissuers to various application paragraphs.

6. This amendment is effective for audits of financial statements for periods ending on or after December 15, 2023.

[No amendment to paragraphs .01–A9.]

.A10 When management uses a management's specialist in preparing the financial statements, the auditor's decision on whether to use an auditor's specialist also may be influenced by such factors as the following:

- 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 ***management's specialist (including, when applicable, the organization that employs the individual specialist), thereby influencing the*** work of the management's specialist
- The competence and capabilities of the management's specialist
- Whether the management's specialist is subject to technical performance standards or other professional or industry requirements
- Any controls within the entity over the work of the management's specialist
- The auditor's ability to evaluate the work and findings of the management's specialist without the assistance of an auditor's specialist

[No amendment to paragraphs .A11–A19.]

.A20 The evaluation of the significance of threats to objectivity and of whether a need exists for safeguards may depend upon the role of the auditor's specialist and the significance of the specialist's work in the context of the audit. There may be some circumstances in which safeguards cannot reduce threats to an acceptable level (for example, if a proposed auditor's

specialist is an individual *or organization that* has played a significant role in preparing the information that is being audited [that is, if the proposed auditor's specialist is a management's specialist]).

.A21 When evaluating the objectivity of an auditor's external specialist, *in addition to considering information obtained from procedures performed in accordance with AU-C section 550, Related Parties*, the auditor may

a. inquire of the entity and the auditor's specialist about any known interests or relationships that the entity has with the auditor's external specialist (*including, when applicable, the organization that employs the individual specialist*) that may affect that specialist's objectivity ~~or~~

b. discuss with that specialist any applicable safeguards, including any professional requirements that apply to that specialist, and evaluate whether the safeguards are adequate to reduce threats to an acceptable level. Interests and relationships that may be relevant to discuss with the auditor's specialist include the following:

i. Financial interests

ii. Business and personal relationships *between the entity and the individual specialist and between the entity and the organization that employs the individual specialist*

iii. Provision of other services *to the entity* by the specialist, including by the organization in the case of an external specialist that is an organization

In some cases, the auditor may obtain a written representation from the auditor's external specialist about any interests or relationships with the entity of which that specialist is aware.

.A22 If the auditor believes a relationship between the entity and the auditor's *external* specialist might impair the objectivity of *that* specialist, the auditor may *perform, or engage another auditor's specialist to perform*, additional procedures with respect to some or all of the assumptions, methods, or findings of the auditor's *external* specialist to determine that the findings are reasonable ~~or may engage another auditor's specialist for that purpose~~. *The nature and extent of the additional procedures depend on the degree of objectivity of the auditor's external specialist. The need for additional procedures to obtain sufficient appropriate audit evidence increases as the degree of objectivity decreases. For example, if the auditor's external specialist has a low degree of objectivity, it may be necessary for the auditor to perform procedures similar to those used to evaluate the appropriateness of the work of a management's specialist as audit evidence.*^{fn13}

^{fn13} See paragraphs .26 and .A69–.A83 of AU-C section 501.

[No amendment to paragraphs .A23–.A29.]

.A30 It often may be relevant when agreeing on the nature, scope, and objectives of the work of the auditor's specialist to include discussion of any relevant technical performance

standards or other professional or industry requirements that the auditor's specialist will follow. *Other matters that could affect the nature, scope, and objectives of the auditor's specialist's work include, as applicable, information about the entity and its environment, the entity's processes for developing the related accounting estimate, the entity's use of specialists in developing the estimate, relevant requirements of the applicable financial reporting framework, and possible accounting and auditing issues.*

.A31 Agreement on the respective roles and responsibilities of the auditor and the auditor's specialist may include the following:

- ~~• Whether the auditor or the auditor's specialist will perform detailed testing of source data~~
- *The degree of responsibility of the auditor's specialist for the following:*
 - *Testing of source data, for example, testing data produced by the entity, or evaluating the relevance and reliability of data from sources external to the entity*
 - *Evaluating the significant assumptions used by the entity or management's specialist, or developing the auditor's specialist's own assumptions*
 - *Evaluating the methods used by the entity or management's specialist, or using the auditor's specialist's own methods*
- Consent for the auditor to discuss the findings or conclusions of the auditor's specialist with the entity and others and to include details of the findings or conclusions of the auditor's specialist in the basis for a modified opinion in the auditor's report, if necessary (see paragraph .A44)
- Any agreement to inform the auditor's specialist of the auditor's conclusions concerning the work of the auditor's specialist

[No amendment to paragraphs .A32–.A34.]

.A35 The auditor's evaluation of the competence, capabilities, and objectivity of the auditor's specialist; the auditor's familiarity with the field of expertise of the auditor's specialist; *the risk of material misstatement in the matter to which the specialist's work relates*; ~~and~~ the nature of the work performed by the auditor's specialist; *and the significance of the auditor's specialist's work in the context of the audit* affect the nature, timing, and extent of audit procedures to evaluate the adequacy of the work of the auditor's specialist for the auditor's purposes.

[No amendment to paragraphs .A36–.A39.]

.A40 When the work of an auditor's specialist involves the use of significant assumptions and methods, the appropriateness and reasonableness of those assumptions and methods used and their application are the responsibility of the auditor's specialist. ***The auditor is responsible for obtaining an understanding of those assumptions and methods and evaluating the relevance and reasonableness of those assumptions and methods in the circumstances.*** ^{fn 16} Factors relevant to the auditor's evaluation of those assumptions and methods include whether they are

- generally accepted within the field of the auditor's specialist;
- consistent with the requirements of the applicable financial reporting framework;
- dependent on the use of specialized models; and
- consistent with those of management and, if not, the reason for, and effects of, the differences.

^{fn 16} Paragraph .13 of AU-C section 540.

.A41 ***AU-C section 500 discusses the auditor's responsibility to consider the relevance and reliability of information to be used as audit evidence, including its source.*** ^{fn 17} When the work of an auditor's specialist involves the use of source data that is significant to the work of the auditor's specialist, procedures such as the following may be used to test that data:

- Verifying the origin of the data, including obtaining an understanding of and, when applicable, testing the internal controls over the data and, when relevant, its transmission to the auditor's specialist
- Reviewing the data for completeness and internal consistency

^{fn 17} Paragraphs .07 and .A12–.A24 of AU-C section 500.

[No amendment to paragraph .A42.]

.A43 ***Examples of situations in which the auditor may conclude that the work of the auditor's specialist is not adequate for the auditor's purposes include the following:***

- ***The specialist's use of data or significant assumptions was not based on consideration of relevant information available to the specialist.***
- ***The methods used by the specialist were not appropriate.***
- ***The specialist's work was not performed in accordance with the auditor's instructions.***
- ***The specialist's findings and conclusions are inconsistent with***
— ***the results of the work performed by the specialist,***

- *other evidence obtained by the auditor, or*
- *the auditor's understanding of the entity and its environment.*
- *The specialist's report, or equivalent documentation, contains restrictions, disclaimers, or limitations that affect the auditor's use of the report or work.*

[No amendment to paragraph .A43, which is renumbered as paragraph .A44.]

.A45 When key audit matters are included in the auditor's report, the auditor may decide to refer to the work of an auditor's specialist in the description of a key audit matter (for example, in describing the auditor's approach to an accounting estimate that has been identified as having high estimation uncertainty, such as the valuation of complex financial instruments, the auditor may highlight that the auditor used an auditor's internal or external specialist). Such a reference does not reduce the auditor's responsibility for the opinion on the financial statements and is, therefore, not inconsistent, in and of itself, with paragraphs .14–.15.^{fn 17}

^{fn17} See paragraph .A48 of AU-C section 701, **Communicating Key Audit Matters in the Independent Auditor's Report**

[No amendment to paragraphs .A44–.A45, which are renumbered as paragraphs .A46–.A47. No further amendment to AU-C section 620.]