

AU Section 9326

Audit Evidence: Auditing Interpretations of Section 326

1. Audit Evidence for an Audit of Interim Financial Statements

.01 Question—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 270-10-45-2 states that "certain accounting principles and practices followed for annual reporting purposes may require modification at interim reporting dates so that the reported results for the interim period may better relate to the results of operations for the annual period." The modifications introduce a need for estimates to a greater extent than is necessary for annual financial information. Does this imply a relaxation of the third standard of field work, which requires that sufficient appropriate audit evidence be obtained to afford a reasonable basis for an opinion regarding the financial statements under audit?

.02 Interpretation—No. The third standard of field work applies to all engagements leading to an expression of opinion on financial statements or financial information.

.03 The objective of the independent auditor's engagement is to obtain sufficient appropriate audit evidence to provide him with a reasonable basis for forming an opinion. The auditor develops specific audit objectives in light of assertions by management that are embodied in financial statement components. Section 326 paragraph .17 states, "the auditor should use relevant assertions for classes of transactions, account balances, and presentation and disclosures in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures. The auditor should use relevant assertions in assessing risks by considering the different types of potential misstatements that may occur, and then designing further audit procedures that are responsive to the assessed risks."

.04 Audit evidence obtained for an audit of annual financial statements may also be useful in an audit of interim financial statements, and audit evidence obtained for an audit of interim financial statements may also be useful in an audit of annual financial statements. Section 318 paragraph .16 states that "The auditor may perform tests of controls or substantive procedures at an interim date or at period end. The higher the risk of material misstatement, the more likely it is that the auditor may decide it is more effective to perform substantive procedures nearer to, or at, the period end rather than at an earlier date, or to perform audit procedures unannounced or at unpredictable times (for example, performing audit procedures at selected locations on an unannounced basis). On the other hand, performing audit procedures before the period end may assist the auditor in identifying significant matters at an early stage of the audit, and consequently resolving them with the assistance of management or developing an effective audit approach to address such matters."^[1]

^[1] [Footnote deleted to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 106.]

.05 The introduction by FASB ASC 270, *Interim Reporting*, of a need for additional estimates in measuring certain items for interim financial information may lead to a need for evidence in examining those items that differs from the evidence required in an audit of annual financial information. For example, computing the provision for federal income taxes in interim information involves estimating the effective tax rate expected to be applicable for the full fiscal year, and the auditor should examine evidence as to the basis for estimating that rate. Since the effective tax rate for the full year ordinarily is known at year-end, similar evidence is not usually required in examining annual information.

[Issue Date: February 1974; Modified: October 1980; Revised: March 2006; Revised: June 2009.]

2. The Effect of an Inability to Obtain Audit Evidence Relating to Income Tax Accruals

.06 *Question*—The Internal Revenue Service's audit manual instructs its examiners on how to secure from corporate officials "tax accrual workpapers" or the "tax liability contingency analysis," including, "a memorandum discussing items reflected in the financial statements as income or expense where the ultimate tax treatment is unclear." The audit manual states that the examiner may question or summons a corporate officer or manager concerning the "knowledge of the items that make up the corporation's contingent reserve accounts." It also states that "in unusual circumstances, access may be had to the audit or tax workpapers" of an independent accountant or an accounting firm after attempting to obtain the information from the taxpayer. IRS policy also includes specific procedures to be followed in circumstances involving "Listed Transactions," to help address what the IRS considers to be abusive tax avoidance transactions (Internal Revenue Manual, section 4024.2-.5, 5/14/81, and Internal Revenue Service Announcement 2002-63, 6/17/02).

.07 Concern over IRS access to tax accrual working papers might cause some clients to not prepare or maintain appropriate documentation of the calculation or contents of the accrual for income taxes included in the financial statements, or to deny the independent auditor access to such information.

.08 What effect does this situation have on the auditor's opinion on the financial statements?

.09 *Interpretation*—The client is responsible for its tax accrual, the underlying support for the accrual, and the related disclosures. Limitations on the auditor's access to information considered necessary to audit the tax accrual will affect the auditor's ability to issue an unqualified opinion on the financial statements. Thus, if the client does not have appropriate documentation of the calculation or contents of the accrual for income taxes and denies the auditor access to client personnel responsible for making the judgments and estimates relating to the accrual, the auditor should assess the importance of that inadequacy in the accounting records and the client imposed limitation on his or her ability to form an opinion on the financial statements. Also, if the client has appropriate documentation but denies the auditor access to it and to client personnel who possess the information, the auditor should assess the importance of the client-imposed scope limitation on his or her ability to form an opinion.

.10 The third standard of field work requires the auditor to obtain sufficient appropriate audit evidence through, among other things, inspection and inquiries to afford a reasonable basis for an opinion on the financial statements. Section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, paragraph .76, requires the

auditor to obtain sufficient appropriate audit evidence about material financial statement assertions or else to qualify or disclaim his or her opinion on the statements. Section 508, *Reports on Audited Financial Statements*, paragraph .24, states that, "When restrictions that significantly limit the scope of the audit are imposed by the client, ordinarily the auditor should disclaim an opinion on the financial statements." Also, section 333 on *Management Representations* requires the auditor to obtain written representations from management. Section 333 paragraph .06 states that specific representations should relate to the following matters, "availability of all financial records and related data," and section 333 paragraph .08 states that a materiality limit does not apply to that representation. Section 333 paragraph .13 states that "management's refusal to furnish a written representation" constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion.

.11 Question—A client may allow the auditor to inspect its tax accrual workpapers, but request that copies not be retained for audit documentation, particularly copies of the tax liability contingency analysis. The client also may suggest that the auditor not prepare and maintain similar documentation of his or her own. What should the auditor consider in deciding a response to such a request?

.12 Interpretation—Section 339, *Audit Documentation*, states that audit documentation is the principal record of auditing procedures applied, evidence obtained, and conclusions reached by the auditor in the engagement. Audit documentation should include sufficient appropriate audit evidence to afford a reasonable basis for an opinion. In addition, audit documentation should be sufficient to enable an experienced auditor to understand the nature, timing, extent, and results of auditing procedures performed, and the evidence obtained. Section 326, *Audit Evidence*, paragraph .05, states that other information includes information obtained by the auditor from inquiry, observation, inspection, and physical examination. The quantity, type, and content of audit documentation are matters of the auditor's professional judgment (see section 339).

.13 The auditor's documentation of the results of auditing procedures directed at the tax accounts and related disclosures also should include sufficient appropriate audit evidence about the significant elements of the client's tax liability contingency analysis. This documentation should include copies of the client's documents, schedules, or analyses (or auditor-prepared summaries thereof) to enable the auditor to support his or her conclusions regarding the appropriateness of the client's accounting and disclosure of significant tax-related contingency matters. The audit documentation should reflect the procedures performed and conclusions reached by the auditor and, for significant matters, include the client's documentary support for its financial statement amounts and disclosures.

.14 The audit documentation should include the significant elements of the client's analysis of tax contingencies or reserves, including roll-forward of material changes to such reserves. In addition, the documentation should provide the client's position and support for income tax related disclosures, such as its effective tax rate reconciliation, and support for its intra-period allocation of income tax expense or benefit to continuing operations and to items other than continuing operations. Where applicable, the documentation also should include the client's basis for assessing deferred tax assets and related valuation allowances and its support for applying the "indefinite reversal criteria" in FASB ASC 740-30-25-17, including its specific plans for reinvestment of undistributed foreign earnings.

.15 Question—In some situations, a client may furnish its outside legal counsel or in-house legal or tax counsel with information concerning the tax contingencies covered by the accrual for income taxes included in the financial statements and ask counsel to provide the auditor an opinion on the adequacy of the accrual for those contingencies.

.16 In such circumstances, rather than inspecting and obtaining documentary evidence of the client's tax liability contingency analysis and making inquiries of the client, may the auditor consider the counsel as a specialist within the meaning of AU section 336, *Using the Work of a Specialist*, and rely solely on counsel's opinion as an appropriate procedure for obtaining audit evidence to support his or her opinion on the financial statements?

.17 Interpretation—No. The opinion of legal counsel in this situation would not provide sufficient appropriate audit evidence to afford a reasonable basis for an opinion on the financial statements.

.18 Section 336 paragraph .01 defines a specialist as "a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing." It is intended to apply to situations requiring special knowledge of matters about which the auditor does not have adequate technical training and proficiency. The auditor's education, training, and experience, on the other hand, do enable him or her to be knowledgeable concerning income tax matters and competent to assess their presentation in the financial statements.

.19 The opinion of legal counsel on specific tax issues that he or she is asked to address and to which he or she has devoted substantive attention, as contemplated by section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, can be useful to the auditor in forming his or her own opinion. However, the audit of income tax accounts requires a combination of tax expertise and knowledge about the client's business that is accumulated during all aspects of an audit. Therefore, as previously stated, it is not appropriate for the auditor to rely solely on such legal opinion.

.20 Question—A client may have obtained the advice or opinion of an outside tax adviser related to the tax accrual or matters affecting it, including tax contingencies, and further may attempt to limit the auditor's access to such advice or opinion, or limit the auditor's documentation of such advice or opinion. This limitation on the auditor's access may be proposed on the basis that such information is privileged. Can the auditor rely solely on the conclusions of third party tax advisers? What audit evidence should the auditor obtain and include in the audit documentation?

.21 Interpretation—As discussed in paragraphs .17–.19, the auditor cannot accept a client's or a third party's analysis or opinion with respect to tax matters without careful consideration and application of the auditor's tax expertise and knowledge about the client's business. As a result of applying such knowledge to the facts, the auditor may encounter situations in which the auditor either disagrees with the position taken by the client, or its advisers, or does not have sufficient appropriate audit evidence to support his or her opinion.

.22 If the client's support for the tax accrual or matters affecting it, including tax contingencies, is based upon an opinion issued by an outside adviser with respect to a potentially material matter, the auditor should obtain access to the opinion, notwithstanding potential concerns regarding attorney-client or other forms of privilege. The audit documentation should include either the actual advice or opinions rendered by an outside adviser, or other sufficient documentation or abstracts supporting both the transactions or facts addressed as well as the analysis and conclusions reached by the client and adviser. Alternatives such as redacted or modified opinions may be considered, but must nonetheless

include sufficient content to articulate and document the client's position so that the auditor can formulate his or her conclusion. Similarly, it may be possible to accept a client's analysis summarizing an outside adviser's opinion, but the client's analysis must provide sufficient appropriate audit evidence for the auditor to formulate his or her conclusion. In addition, client representations may be obtained stating that the client has not received any advice or opinions that are contradictory to the client's support for the tax accrual.

.23 If the auditor is unable to accumulate sufficient appropriate audit evidence about whether there is a supported and reasonable basis for the client's position, the auditor should consider the effect of this scope limitation on his or her report.

[Issue Date: March 1981; Amended: April 9, 2003; Revised: December 2005; Revised: March 2006; Revised: March 2008; Revised: June 2009.]

3. The Auditor's Consideration of the Completeness Assertion

.24 *Question*—Section 326, *Audit Evidence*, paragraphs .14–.19, discusses the use of assertions that are embodied in financial statement components. In obtaining audit evidence about certain assertions such as, existence or occurrence, rights and obligations, valuation or allocation, and presentation and disclosure, the auditor may consider classes of transactions, account balances and disclosures that are included in the financial statements. In contrast, in obtaining audit evidence about the completeness assertion related to classes of transactions, account balances and disclosures, the auditor may consider whether transactions, accounts and disclosures have been improperly excluded from the financial statements. May management's written representations and the auditor's assessment of control risk constitute sufficient audit evidence about the completeness assertion? [Paragraph renumbered by the amendment to Interpretation No. 2, April 2003.]

.25 *Interpretation*—Written representations from management are a part of the audit evidence the auditor may obtain in an audit performed in accordance with generally accepted auditing standards. Management's representations about the completeness assertion, whether considered alone or in combination with the auditor's assessment of control risk, do not constitute sufficient appropriate audit evidence to support that assertion. Obtaining such representations complements but does not replace other auditing procedures that the auditor should perform. [Paragraph renumbered by the amendment to Interpretation No. 2, April 2003.]

.26 In planning audit procedures to obtain evidence about the completeness assertion, the auditor should consider the inherent risk that transactions and accounts have been improperly omitted from the financial statements. When the auditor assesses the inherent risk of omission for a particular account balance or class of transactions to be such that he believes omissions could exist that might be material when aggregated with errors in other balances or classes, he should restrict the audit risk of omission by performing substantive tests designed to obtain evidence about the completeness assertion. Substantive tests designed primarily to obtain evidence about the completeness assertion include analytical procedures and tests of details of *related populations*.² [Paragraph renumbered by the amendment to Interpretation No. 2, April 2003.]

² For purposes of this interpretation, a related population is a population other than the recorded account balance or class of transactions being audited that would be expected to contain evidence of whether all accounts or transactions that should be presented in that balance or class are so included.

.27 The extent of substantive tests of completeness may properly vary in relation to the assessed level of control risk. Because of the unique nature of the completeness assertion, an assessed level of control risk below the maximum may be an effective means for the auditor to obtain evidence about that assertion. Although an assessed level of control risk below the maximum is not required to satisfy the auditor's objectives with respect to the completeness assertion, the auditor should consider that for some transactions (for example, revenues that are received primarily in cash, such as those of a casino or of some charitable organizations) it may be difficult to limit audit risk for those assertions to an acceptable level without an assessed level of control risk below the maximum. [Paragraph renumbered by the amendment to Interpretation No. 2, April 2003.]

[Issue Date: April 1986; Revised: March 2006.]

[4.] Applying Auditing Procedures to Segment Disclosures in Financial Statements

[.28-.41] ^[3] [Deleted March 2006.]

^[3] [Footnote deleted to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 106.]