

## AU-C Section 9500

# Audit Evidence: Auditing Interpretations of Section 500

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

**.01 Question**—The IRS'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).

**.02** Concern over IRS access to tax accrual working papers might cause some entities 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.

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

**.04 Interpretation**—The entity 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 unmodified opinion on the financial statements.

**.05** The auditor is required to design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence.<sup>1</sup>

**.06** If the entity does not have appropriate documentation of the calculation or contents of the accrual for income taxes and denies the auditor access to entity personnel responsible for making the judgments and estimates relating to the accrual, the auditor is required to conclude whether sufficient appropriate audit evidence has been obtained. If the auditor has not obtained sufficient appropriate audit evidence about a relevant assertion, the auditor is required to attempt to obtain further audit evidence.<sup>2</sup>

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<sup>1</sup> Paragraph .06 of section 500, *Audit Evidence*.

<sup>2</sup> Paragraphs .28–.29 of section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.

**.07** If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor is required to express a qualified opinion or disclaim an opinion on the financial statements.<sup>3</sup>

**.08** If the entity has appropriate documentation but denies the auditor access to it and to entity personnel who possess the information, the auditor is required to perform procedures to evaluate the consequence of an inability to obtain sufficient appropriate audit evidence due to a management-imposed limitation.<sup>4</sup>

**.09** The auditor is required to request management to provide a written representation that it has provided the auditor with all relevant information and access, as agreed upon in the terms of the audit engagement.<sup>5</sup> If management does not provide the written representations required by section 580, *Written Representations*, the auditor is required to disclaim an opinion on the financial statements in accordance section 705, *Modifications to the Opinion in the Independent Auditor's Report*, or withdraw from the engagement.<sup>6</sup>

**.10 Question**—An entity 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 entity also may suggest that the auditor not prepare and maintain similar documentation of his or her own. What are the auditor's requirements in deciding a response to such a request?

**.11 Interpretation**—Section 230, *Audit Documentation*, defines *audit documentation* as the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached.<sup>7</sup> The auditor is required to prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand

- a. the nature, timing, and extent of the audit procedures performed to comply with generally accepted auditing standards and applicable legal and regulatory requirements;
- b. the results of the audit procedures performed and the audit evidence obtained; and
- c. significant findings or issues arising during the audit, the conclusions reached thereon, and significant judgments made in reaching those conclusions.<sup>8</sup>

Section 500, *Audit Evidence*, 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 judgment.

**.12** The audit documentation of the results of auditing procedures directed at the tax accounts and related disclosures also includes sufficient appropriate audit evidence about the significant elements of the entity's tax liability contingency analysis. This audit documentation includes copies of the entity's documents, schedules, or analyses (or auditor-prepared summaries thereof) to enable the auditor to support his or her conclusions regarding the appropriateness

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<sup>3</sup> Paragraphs .08 and .10 of section 705, *Modifications to the Opinion in the Independent Auditor's Report*.

<sup>4</sup> Paragraphs .11–.14 of section 705.

<sup>5</sup> Paragraph .11a of section 580, *Written Representations*.

<sup>6</sup> Paragraph .25 of section 580.

<sup>7</sup> Paragraph .06 of section 230, *Audit Documentation*.

<sup>8</sup> Paragraph .08 of section 230.

of the entity's accounting and disclosure of significant tax-related contingency matters. The audit documentation reflects the procedures performed and conclusions reached by the auditor and, for significant matters, include the entity's documentary support for its financial statement amounts and disclosures.

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

**.14 Question**—In some situations, an entity may furnish its external 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.

**.15** In such circumstances, rather than inspecting and obtaining documentary evidence of the entity's tax liability contingency analysis and making inquiries of the entity, may the auditor consider the counsel as a management's specialist within the meaning of section 500 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?

**.16 Interpretation**—No. The opinion of legal counsel in this situation does not provide sufficient appropriate audit evidence to afford a reasonable basis for an opinion on the financial statements. 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 the legal counsel's response to an auditor's letter of inquiry, can be useful to the auditor in forming his or her own opinion.

**.17** An opinion from an entity's legal or tax counsel, similar to other work products obtained from a management's specialist, is useful in situations in which the auditor does not have adequate technical training and proficiency. In this case, however, 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.

**.18** Therefore, while the opinion of legal counsel on specific tax issues can be useful to the auditor in forming his or her own opinion, the audit of income tax accounts requires a combination of tax expertise and knowledge about the entity'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.

**.19 Question**—A entity 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?

**.20 Interpretation**—As discussed in paragraphs .16–.18 of this interpretation, the auditor cannot accept an entity'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 entity'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 entity, or its advisers, or does not have sufficient appropriate audit evidence to support his or her opinion.

**.21** If the entity'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 is required to obtain access to the opinion,<sup>9</sup> notwithstanding potential concerns regarding attorney-client or other forms of privilege. The audit documentation includes 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 entity and adviser. Alternatives such as redacted or modified opinions may be considered but must, nonetheless, include sufficient content to articulate and document the entity's position so that the auditor can formulate his or her conclusion. Similarly, it may be possible to accept an entity's analysis summarizing an outside adviser's opinion, but the entity's analysis must provide sufficient appropriate audit evidence for the auditor to formulate his or her conclusion. In addition, written representations may be obtained stating that the entity has not received any advice or opinions that are contradictory to the entity's support for the tax accrual.

**.22** If the auditor is unable to accumulate sufficient appropriate audit evidence about whether there is a supported and reasonable basis for the entity's position, the auditor is required to consider the effect of this scope limitation on his or her opinion.<sup>10</sup>

[Issue Date: March 1981; Amended: April 9, 2003; Revised: December 2005; Revised: March 2006; Revised: March 2008; Revised: June 2009; Revised: October 2011, effective for audits of financial statements for periods ending on or after December 15, 2012.]

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<sup>9</sup> Paragraph .11 of this interpretation.

<sup>10</sup> Paragraphs .11–.14 of section 705.

### New GASB Pension Standards

In June 2012, the Governmental Accounting Standards Board (GASB) issued two new standards that will substantially change the accounting and financial reporting of public employee pension plans and the state and local governments that participate in such plans. GASB Statement No. 67, *Financial Reporting for Pension Plans*, revises existing guidance for the financial reports of most governmental pension plans. GASB Statement No. 68, *Accounting and Financial Reporting for Pensions*, revises and establishes new financial reporting requirements for most governments that provide their employees with pension benefits. GASB Statement No. 67 is effective for financial statements for periods beginning after June 15, 2013. GASB Statement No. 68 is effective for financial statements for fiscal years beginning after June 15, 2014.

Interpretation No. 2, "Auditor of Participating Employer in a Governmental Cost-Sharing Multiple-Employer Pension Plan" (paragraphs .23–.29), Interpretation No. 3, "Auditor of Participating Employer in a Governmental Agent Multiple-Employer Pension Plan" (paragraphs .30–.36), and Interpretation Nos. 1–2 of section 805, *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement*, are intended to assist both plan and employer auditors who are auditing entities that have implemented the new accounting standards.

## 2. Auditor of Participating Employer in a Governmental Cost-Sharing Multiple-Employer Pension Plan

**.23 Question**—GASB Statement No. 68 requires governmental entities (employers) participating in governmental cost-sharing multiple-employer pension plans (cost-sharing plan or plan) to present certain pension amounts in employer financial statements that are calculated by the plan or its actuary. Such amounts are based, in part, on records maintained only by the plan.

**.24** Do the audited financial statements of the plan prepared in accordance with generally accepted accounting principles (GAAP) and additional unaudited information provided by the plan's management necessary to calculate the employer's net pension liability provide the employer's auditor with sufficient appropriate audit evidence upon which to base the opinion on the affected opinion units of the governmental employer financial reporting entity?

**.25 Interpretation**—No. GASB Statement No. 67 requires only the disclosure of the collective net pension liability for all participating employers in GAAP financial statements of cost-sharing plans, not each employer's proportionate share of the collective net pension liability. Further, GAAP does not require the plan to present deferred outflows of resources or deferred inflows of resources by category, pension expense, or each participating employer's share of collective pension amounts. Unaudited information provided by the plan's management to the employers to support allocations or pension amounts that has not been subjected to further audit procedures beyond those performed in the audit of the basic plan financial statements would not constitute sufficient appropriate audit evidence to support the relevant assertions in the employer's

financial statements related to the pension amounts, including required disclosures.

**.26** Absent additional audit evidence from the cost-sharing plan (for example, auditor's opinions on the schedule of employer allocations and certain key elements including net pension liability, total deferred outflows of resources, total deferred inflows of resources, and total pension expense in a schedule of pension amounts), the employer auditor would not likely be able to accumulate sufficient appropriate audit evidence to support the pension amounts and disclosures in the employer's financial statements. When pension amounts are material to one or more applicable opinion units of the employer's financial statements and the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements of those opinion units are free from material misstatement, the auditor should modify the audit opinion pursuant to section 705.

**.27 Question**—A plan has engaged its auditor to audit and report on the schedule of employer allocations and certain key elements including net pension liability, total deferred outflows of resources, total deferred inflows of resources, and total pension expense in a schedule of pension amounts, as described in the AICPA's State and Local Governments Expert Panel white paper *Governmental Employer Participation in Cost-Sharing Multiple-Employer Plans: Issues Related to Information for Employer Reporting*. May an employer auditor use the plan auditor's report as evidence for the audit of the employer's financial statements?

**.28 Interpretation**—Yes. The employer auditor is solely responsible for the audit of the employer's financial statements and, therefore, is responsible for determining the sufficiency and appropriateness of audit evidence necessary to reduce audit risk to an appropriately low level. Nevertheless, the employer auditor may use the plan auditor's report on the schedules as evidence that the pension amounts allocated to the employer and included in the employer's financial statements are not materially misstated.

**.29** Before using the report of the plan auditor as evidence, the employer auditor should evaluate whether the plan auditor's report and accompanying schedules are adequate and appropriate for the employer auditor's purposes. For example, the employer auditor may review the plan auditor's report and any related opinion modifications and assess other matters discussed in the report. Additionally, the employer auditor should evaluate whether the plan auditor has the necessary competence and independence for the employer auditor's purposes. Further, the employer auditor has a responsibility to verify and recalculate amounts specific to the applicable employer, including the employer amount used in the allocation percentage (that is, the numerator of the calculation), to recalculate the allocation percentage for the employer, and to recalculate the pension amounts allocated to the employer based on the allocation percentage.

[Issue Date: April 2014.]

### 3. Auditor of Participating Employer in a Governmental Agent Multiple-Employer Pension Plan

**.30 Question**—GASB Statement No. 68 requires governmental entities (employers) participating in governmental agent multiple-employer pension plans (agent plan or plan) to present certain pension amounts in employer

financial statements that are calculated by the plan or its actuary. Such amounts are based, in part, on records maintained only by the plan.

**.31** Do the audited financial statements of the plan prepared in accordance with GAAP and additional unaudited information provided by the plan's management necessary to calculate the employer's net pension liability provide the employer's auditor with sufficient appropriate audit evidence upon which to base the opinion on the affected opinion units of the governmental employer financial reporting entity?

**.32 Interpretation**—No. GASB Statement No. 67 does not require the plan to present net pension liability, deferred outflows of resources or deferred inflows of resources by category, pension expense, or each participating employer's specific pension amounts. Unaudited information provided by the plan's management to the employers to support allocations or pension amounts that has not been subjected to further audit procedures beyond those performed in the audit of the basic plan financial statements would not constitute sufficient appropriate audit evidence to support the relevant assertions in the employer's financial statements related to the pension amounts, including required disclosures.

**.33** Absent additional evidence obtained, for example, through the suggested best practices as described in the AICPA's State and Local Governments Expert Panel white paper *Governmental Employer Participation in Agent Multiple-Employer Plans: Issues Related to Information for Employer Reporting*, the employer auditor would not likely be able to accumulate sufficient appropriate audit evidence to support the pension amounts and disclosures in the employer's financial statements. When pension amounts are material to one or more applicable opinion units of the employer's financial statements and the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements of those opinion units are free from material misstatement, the auditor should modify the audit opinion pursuant to section 705.

**.34 Question**—A plan has engaged its auditor to audit and report on the schedule of changes in fiduciary net position by employer, as described in the AICPA's State and Local Governments Expert Panel white paper referenced in paragraph .33 of this interpretation. May an employer auditor use the plan auditor's report as evidence about the fiduciary net position and changes in fiduciary net position for the audit of the employer's financial statements?

**.35 Interpretation**—Yes. The employer auditor is solely responsible for the audit of the employer's financial statements and, therefore, is responsible for determining the sufficiency and appropriateness of audit evidence necessary to reduce audit risk to an appropriately low level. Nevertheless, the employer auditor may use the plan auditor's report on the schedule as evidence about both the fiduciary net position and changes in fiduciary net position of the employer. However, the employer auditor should consider whether the opinion is on the schedule as a whole or on each employer column. If the opinion is on the schedule as a whole, it is likely that the employer auditor will need additional evidence to support these amounts in the employer's financial statements (examples of such audit evidence are included in the white paper referenced in paragraph .33 of this interpretation).

**.36** Before using the work of the plan auditor as evidence, the employer auditor should evaluate whether the plan auditor's report and accompanying schedule are adequate and appropriate for the employer auditor's purposes. For example, the employer auditor may review the plan auditor's report and any

related opinion modifications and assess other matters discussed in the report. Additionally, the employer auditor should evaluate whether the plan auditor has the necessary competence and independence for the employer auditor's purposes.

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