

# Evaluating Evidence and Workpapers: Is It Enough?

EEW4/26/V1

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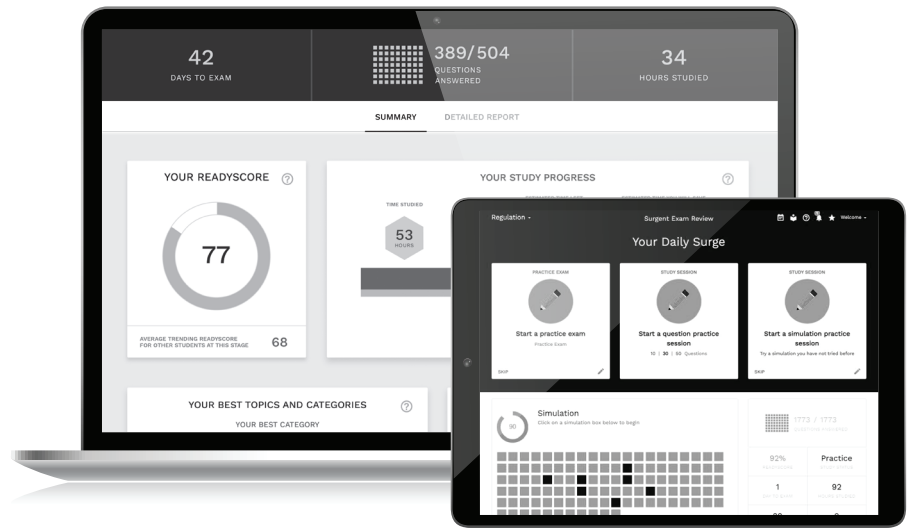
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# Reviewing Audit Workpapers

## *Learning objectives*

After completing this chapter, the reader should be able to:

- Discuss the importance of documentation and how it fits in with the overall audit quality process;
- Discuss tips for an efficient workpaper review process that complies with professional standards;
- Explain the roles that the various levels in the firm play in workpaper review;
- Describe how the workpapers should be complete, accurate, and able to stand on their own; and
- Describe areas for the reviewer to focus on in risk assessment, internal control, substantive testing, concluding, and reporting.

## **I. Introduction**

Audit documentation provides the principal support for the independent auditor's report. Therefore, it is important that workpapers meet professional standards. Anything less could result in peer or regulatory review deficiencies, and as a worse case, lawsuits when fraud occurs at a company. Even though the auditor is not responsible for identifying fraud, they are responsible for planning and performing the audit to obtain reasonable assurance that the financial statements are free from material misstatement due to fraud or error. Effective workpaper review is an important part of meeting professional standards at the engagement level as well as the overall firm level. In addition, the workpaper review process should be used as a tool for professional development and promoting efficient audits. This module will provide the tips and tools for satisfying these important workpaper reviewer responsibilities for auditors at the in-charge or newer manager levels.

### **A. Purpose of documentation**

Audit documentation is an extremely important part of a financial statement audit. Documentation provides evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the engagement as well as evidence that the audit was planned and performed in accordance with generally accepted auditing standards (GAAS) and applicable legal and regulatory requirements.

The reviewer should keep in mind that audit documentation also serves to:

- a. Assist the engagement team to plan and perform the audit;
- b. Assist members of the engagement team responsible for supervision to direct and supervise the audit work and to complete their review responsibilities;
- c. Enable the engagement team to evidence the procedures performed, the audit evidence examined, and the conclusions reached;
- d. Provide a record of matters of continuing significance to future audits of the same entity;
- e. Enable the conduct of quality management reviews and inspections;
- f. Enable the conduct of external inspections or peer reviews in accordance with applicable legal, regulatory, or other requirements;
- g. Assist an auditor who reviews a predecessor auditor's audit documentation; and
- h. Assist auditors in understanding the work performed in the prior year as an aid in planning and performing the current engagement.

## B. Levels and roles of reviewers

Accounting firms come in all sizes and there are no standard titles and responsibilities that span across all firms. In addition, smaller firms tend to be flatter with fewer levels and less sophisticated clients. In this regard, a person with one year of experience may be performing original work but so may a person with five or more years of experience. The following table contains a description of roles, possible titles, and review responsibilities.

Level	Description	Title(s)	Review Responsibilities
Nonsupervisory auditors	Auditors in these roles plan or perform engagement procedures. Work situations for these auditors are characterized by low levels of ambiguity, complexity, and uncertainty. The nonsupervisory auditor role necessitates at least a basic level of proficiency.	Staff	A nonsupervisory auditor is responsible for reviewing their own work for accuracy and completeness.
Supervisory auditors	Auditors in these roles plan engagements, perform engagement procedures, or direct engagements. Work situations for these auditors are characterized by moderate levels of ambiguity, complexity, and uncertainty. The supervisory auditor role necessitates at least an intermediate level of proficiency.	Senior, in-charge, manager, senior manager	The supervisory auditor spans a large range. In some firms the supervisory auditor performs original work and then may review the work of others. Therefore, a senior, in-charge, manager, senior manager or even a partner may perform the initial review (sometimes referred to as detail review or the first-level review). This depends on the size and complexity of the engagement and the resources of the firm. This module addresses the reviews performed by supervisory auditors.
Partners and directors	Auditors in these roles plan engagements, perform engagement procedures, or direct or report on engagements. Partners and directors may also be responsible for reviewing engagement quality prior to issuing the report, for signing the report, or both.	Partner, principal, firm director	This level includes both the engagement partner and any partner responsible for engagement quality review.  The partner has the ultimate responsibility for the overall quality on each individual engagement. Not all firms require EQR, and some require it on all engagements. Some firms required it on new engagements, high risk engagements and on must-select engagements.

The auditor does **not** perform quality work just to please the peer reviewer or regulatory reviewer. However, their work is open to scrutiny. Therefore, it is important for those responsible for reviewing the work of others to understand the places where errors and omissions generally occur.

## **II. Quality management**

### **A. AICPA Audit Quality Initiative**

The AICPA launched its Enhancing Audit Quality (EAQ) initiative in 2014 in part due to the criticisms of regulators that were finding deficiencies in single audits and ERISA audits. The initiative contains within it a data-driven approach to improving audit quality. In this initiative, the AICPA:

- a. Collects data from peer reviews and other reviews, for example, from regulatory agencies;
- b. Analyzes the data to see where deficiencies are prevalent;
- c. Studies emerging trends; and
- d. Takes action to create articles, webcasts, tools, and other resources to help auditors improve.

The AICPA publishes reports each year on the activities within its EAQ and identifies where peer reviewers and others are finding deficiencies. This information is helpful to the workpaper reviewer because it helps to identify points of focus. The 2026 areas of focus are risk assessment, quality management, technology-enabled audit, single audit, and emerging engagements (added in 2025).

### **B. Recently issued quality management standards**

This section provides an overview of the standards and highlights significant changes. Participants should review the quality standards for full descriptions.

#### **1. Overview**

The AICPA Auditing Standards Board (ASB) issued new Statements on Quality Management Standards (SQMS Nos. 1 and 2) and Statement on Auditing Standards (SAS) No. 146 on quality management at the engagement level in 2022. SQMS No. 3 was issued in 2023. SQMS No. 3 was issued to incorporate the changes from SAS No. 149 into group audits. Statement on Standards for Accounting and Review Services (SSARS) No. 26 and Statement on Standards for Attestation Engagements (SSAE) No. 23 complete the risk assessment suite. Like SAS No. 146, these two standards address quality at the engagement level for SSARS and attestation engagements.

All the standards are effective for 2026 engagements.

The standards address comments made by peer reviewers and regulators:

- a. Risk in audits, reviews, and attestation engagements is correlated with engagement partners who perform a low volume of these engagements;
- b. There is a lack of focus on planning;
- c. There is an overreliance on practice aids and quality management materials from third-party vendors, which are often not tailored to the circumstances of a firm or engagement;
- d. Smaller firms experience challenges in applying the standards; and
- e. Firm governance and leadership (including culture and tone from the top of the firm) need improvement.

The most significant change from the legacy quality control standards is the introduction of a risk-based approach to achieving quality objectives. The firm will perform an assessment to identify and then address the risks that are specific to its practice. The intent is to produce a more scalable approach, which is also a trend in audit literature in general.

## 2. *Interrelated standards*

The three quality management standards are interrelated. The overarching theme is an accounting firm's system of quality management. Two significant components of that system are engagement quality reviews (EQRs) and quality management at the individual engagement level, as illustrated below.

## 3. *Effective dates and applicability*

<b>Standard</b>	<b>Effective Date</b>	<b>Applies To</b>
<i>SQMS No. 1, A Firm's System of Quality Management</i>	Systems of quality management were required to be designed and implemented by December 15, 2025, and the evaluation of the system of quality management is required to be performed within one year following December 15, 2025.	Firms that perform audits, attestation engagements, reviews, compilations, and any other services for which standards have been issued by the AICPA
<i>SQMS No. 2, Engagement Quality Reviews</i>	Currently effective for audits or reviews of financial statements and other engagements in the firm's accounting and auditing practice for periods beginning on or after December 15, 2025.	Any engagement where an EQR is required by firm policy or deemed to be an appropriate response to risk
<i>SQMS No. 3, Amendments to QM Sections 10 and 20</i>	Effective concurrently with a firm's implementation of SQMS Nos. 1 and 2 by December 15, 2025.	Audits only
<i>SAS No. 146, Quality Management for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards</i>	Currently effective for engagements conducted in accordance with generally accepted auditing standards for periods beginning on or after December 15, 2025.	Audits only
<i>SSARS No. 26, Quality Management for an Engagement Conducted in Accordance With Statements on Standards for Accounting and Review Services</i>	Currently effective for periods beginning on or after December 15, 2025.	SSARS engagements
<i>SSAE No. 23, Amendments to the Attestation Standards for Consistency With the Issuance of AICPA Standards on Quality Management</i>	Currently effective for engagements beginning on or after December 15, 2025.	SSAE engagements

#### **4. Objectives of quality management**

The objectives of the quality management standards are to:

- a. Increase firm leadership responsibilities and accountability and improve firm governance;
- b. Introduce a risk-based approach focused on achieving quality objectives;
- c. Address technology, networks, and the use of external service providers;
- d. Increase focus on the continual flow of information and appropriate communication, both internally and externally;
- e. Promote proactive monitoring of quality management systems and timely and effective remediation of deficiencies;
- f. Clarify and strengthen requirements for robust EQRs; and
- g. Enhance the engagement partner's responsibility for audit engagement leadership and audit quality.

### **C. SQMS No. 1 – System of quality management**

#### **1. Risk management**

SQMS No. 1 emphasizes an integrated and iterative approach that focuses on assessing risk and a continuous flow of remediation and improvement. This new proactive approach requires a firm to customize its system of quality management rather than tailor a sample document from the firm's practice aids or other sources, which is often the norm for many firms. The firm will customize the design, implementation, and operation of its quality management system based on the risks that may have impacted engagement quality in the past, as well as the nature and complexity of the firm itself. The integrated approach is intended to prompt firms to focus on the quality management system as a whole, rather than on the required components as standalone elements. The new standard was written to be less prescriptive so that it could be easily scalable.

The quality management system should provide the firm with reasonable assurance regarding the achievement of the system's objectives. Note that this assurance is not obtained through independent sources (such as the firm's periodic peer review); rather, it is obtained through the operation of the system itself.

#### **2. Revised components**

The quality management system is required to address the following eight components, which are designed to be integrated throughout the system as illustrated in the graphic below:

1. The firm's risk assessment process (new);
2. Governance and leadership (adapted from leadership responsibilities for quality within the firm in SQCS No. 8);
3. Relevant ethical requirements (adapted from SQCS No. 10);
4. Acceptance and continuance of client relationships and specific engagements (adapted from SQCS No. 8);
5. Engagement performance (adapted from SQCS No. 8);
6. Resources (adapted from human resources in SQCS No. 8);
7. Information and communication (new); and
8. The monitoring and remediation process (adapted from monitoring in SQCS No. 8).

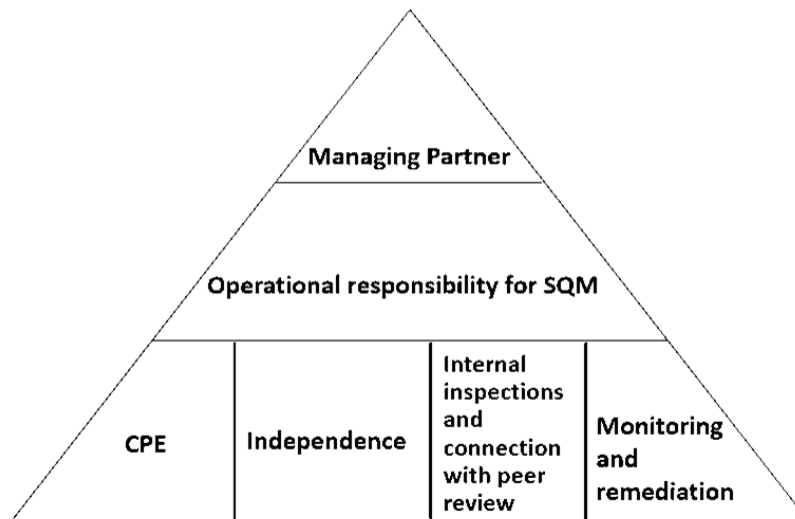


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The following sections will discuss the most significant changes in the components of this standard. Accordingly, not all components will be discussed.

### 3. Getting started

When a firm prepares to implement the new quality management standards, it is important to consider who will be involved in and responsible for this important aspect of practice management. SQMS No. 1 states that the ultimate responsibility and accountability for the system of quality management rests with the managing partner of the firm. Other responsibilities can be delegated.



The firm will generally have an implementation committee because information required for the risk assessment process may come from various sources. For this reason, it is good practice to include people from human resources, information technology, and other practice areas from the firm on the committee.

### 4. NEW risk assessment process (component 1)

Firm leadership is responsible for the establishment of quality objectives, including additional quality objectives when needed based on the nature of the firm and its engagements. The first step in the risk assessment process is to **identify and assess quality risks**. The firm considers the factors that have a

<sup>1</sup> Graphic from IAASB ISQM Fact Sheet 1.

reasonable possibility of adversely affecting the achievement of quality objectives, how the risks arise, how often they are likely to occur, and how long it would take to have an effect on quality, including whether the firm would, in that period of time, be able to respond and mitigate the quality risk.

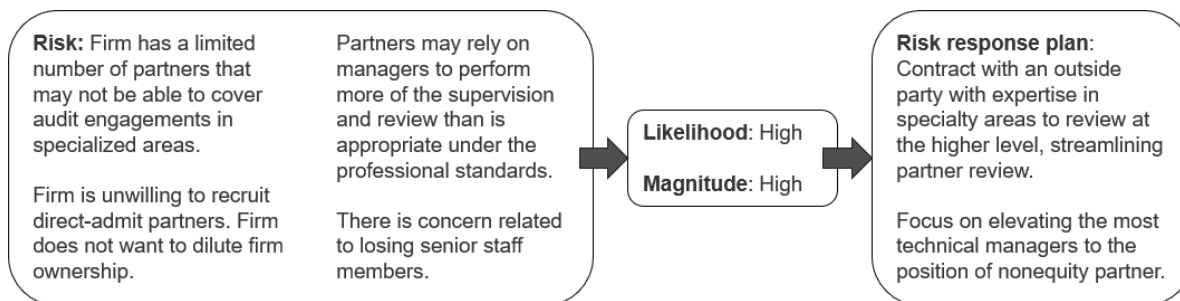
The firm should consider:

- a. The complexity and operating characteristics of the firm;
- b. The strategic and operational decisions, actions, business processes, and business model of the firm;
- c. The characteristics and management style of leadership;
- d. The resources of the firm, including the resources provided by service providers;
- e. Laws, regulations, professional standards, and the environment in which the firm operates; and
- f. When a firm belongs to a network, the nature and extent of the network requirements and network services.

Firm leadership should consider the types of engagements performed by the firm, the reports to be issued, and the types of entities represented by those engagements.

- a. **Evaluate the likelihood and magnitude of this issue affecting firm quality** – Firm leadership will determine if it is reasonably possible that the issue will affect the firm’s quality and how long it will take to manifest in the practice.
- b. **Create a risk response plan** – Leadership will create and implement a risk response plan for those risks that are moderate to high.

**Example:** An accounting firm’s leadership wants to identify and assess risks to the firm’s quality objectives. The firm identifies challenges because there are not enough partners to perform a partner-level review in certain specialty areas. The firm is aware that this situation is not only reasonably possible, but also presently occurring, so it will not take long to impact quality if not addressed. The firm initiates a response accordingly.



## 5. Risk assessment template

To assist accounting firms in using a methodical approach, the AICPA and practice aid vendors have developed tools that cover the quality objectives set forth in SQMS No. 1. The AICPA’s tool is in spreadsheet format and can be customized. An example of a template that has been customized to meet user needs is featured below. It is a portion of the governance and leadership (GL) section. Use of such a template helps to ensure that the firm considers all the SQMS objectives and provides a vehicle for documenting the risk assessment process.

	SQMS 1 Ref.	Quality Objective	Identified Risks	Likelihood	Impact	Overall Assessment	Risk Response	Risk Owner	Testing Frequency	Test Results	Comments
GL 1	10.29	The firm demonstrates a commitment to quality through a culture that exists throughout the firm, which recognizes and reinforces the firm's role in serving the public interest by consistently performing quality engagements.									
GL 2	10.29	The firm demonstrates a commitment to quality through a culture that exists throughout the firm, which recognizes and reinforces the firm's role in serving the public interest by reinforcing the importance of professional ethics, values, and attitudes.									
GL 3	10.29	The firm demonstrates a commitment to quality through a culture that exists throughout the firm, which recognizes and reinforces the responsibility of all personnel for quality relating to the performance of engagements or activities within the system of quality management and their expected behavior.									
GL 4	10.29	The firm demonstrates a commitment to quality through a culture that exists throughout the firm, which recognizes and reinforces the importance of quality in the firm's strategic decisions and actions, including the firm's financial and operational priorities.									
GL 5	10.29	Leadership is responsible and accountable for quality.									
GL 6	10.29	Leadership demonstrates a commitment to quality through its actions and behaviors.									

## 6. Responses to risks

The firm is required to establish policies and procedures to respond to risks in the initial assessment as well as when they arise. The responses identified below are specified in the standard, recognizing that there may be other policies or procedures needed to supplement them. The firm is required to include the following responses in its system of quality management:

- a. Identify, evaluate, and address threats to compliance with ethical requirements;
- b. Identify, communicate, evaluate, and report any breaches of ethical requirements and respond to the causes and consequences of the breaches in a timely manner;
- c. Obtain a confirmation of compliance with independence requirements from all personnel required to be independent (performed at least annually);
- d. Adopt policies for receiving, investigating, and resolving complaints and allegations about failures to perform work in accordance with professional standards, applicable legal and regulatory requirements, or the firm's policies;
- e. Adopt policies to cover instances where the firm becomes aware of information after accepting or continuing a client relationship or engagement that would have caused the firm to decline the relationship or engagement;
- f. Adopt policies to cover instances where the firm is obligated by law or regulation to accept a client relationship or specific engagement;
- g. Establish policies that address when it is appropriate to communicate with external parties about the firm's system of quality management and the form of communication to be provided; and
- h. Establish policies that address engagement quality reviews in accordance with SQMS No. 2 and require an engagement quality review for audits or other engagements for which an engagement quality review is required by law or regulation.

## 7. Engagement performance (component 5)

The engagement performance component includes information about partner responsibilities related to engagement performance. The guidance on partner review is also discussed in SAS No. 146. Peer reviewers have noted that there is not always sufficient partner involvement in engagements. In addition, peer reviewers have noted that partners do not always wait until the engagement quality review is complete before issuing the independent auditor's report. This is addressed in SQMS No. 2.

The following table lists the engagement performance requirements at the partner level.

<b>Partner Responsibility</b>
Determine that the nature, timing, extent of direction, supervision, and review are: (1) performed in accordance with the firm's professional standards and applicable legal and regulatory requirements; and (2) responsive to the nature and circumstances of the audit engagement and the resources used in the audit.
Review audit documentation at appropriate points in time during the audit engagement, including documentation related to significant matters, significant judgments, and other matters that the partner believes are relevant to their responsibilities.
Determine through review of audit documentation and discussion with the engagement team that sufficient appropriate audit evidence has been obtained to support the conclusions reached for the auditor's report to be issued.
Before dating the auditor's report, review the financial statements, the auditor's report, and related audit documentation to determine that the report to be issued will be appropriate in the circumstances. Formal written communications to management, those charged with governance, or regulatory authorities should also be reviewed.

However, the partner may delegate the direction and supervision of the members of the engagement team, as well as the review of their work.

## 8. Resources (component 6)

SQMS No. 1 expands upon SQCS No. 8 to address the following areas:

- a. **Technological resources** such as audit tools or IT applications used by the firm for independence monitoring;
- b. **Intellectual resources** such as the firm's methodology, guidance, templates, or tools;
- c. **Human resources**, which may include people outside the firm used in engagements, including component auditors or engagement quality (EQ) reviewers external to the firm; and
- d. **The use of resources** from service providers such as methodologies, IT applications, or people the firm uses in engagements. The standard provides guidance to determine that those resources are appropriate for the intended use by the firm.

The responsibility for all resources lies with the engagement partner, who is charged with determining that the individuals participating in the engagement collectively have the appropriate competence and capabilities (including sufficient time) to perform the engagement.

## **9. Information and communication (component 7)**

This component is designed to provide guidance enabling a continuous flow of information and communication. It requires the firm to implement an information system that contains procedures to identify, capture, process, and maintain information.

This standard is scalable, acknowledging that less complex firms with fewer personnel and more direct involvement of leadership may accomplish the objective with less rigorous or detailed policies and procedures. The standard addresses both internal and external communication.

## **10. Monitoring and remediation process (component 8)**

Where SQCS No. 8 focused on engagement-level monitoring, SQMS No. 1 focuses on monitoring the system of quality management. A combination of ongoing monitoring and periodic monitoring should result in a proactive response to risks that arise, thereby providing a better basis for management to evaluate the system of quality management.

The firm should design and perform monitoring activities to provide a basis for the identification of deficiencies. When designing the system of quality management, firm leadership considers the nature, timing, and extent of monitoring activities. These are primarily driven by:

- a. The complexity of the firm's engagements;
- b. How the system is designed;
- c. The nature and circumstances of the firm and the engagements it performs;
- d. The extent of changes to the system; and
- e. Other considerations, including:
  - (i) The results of previous monitoring activities;
  - (ii) The relevance of previous monitoring activities; and
  - (iii) The effectiveness of the corrective actions to address previously identified deficiencies.

The system should also consider any complaints and allegations regarding failures to perform work in accordance with professional standards, legal and regulatory requirements, or the firm's policies. This information may become known in peer reviews or from service providers such as those engaged by the firm to perform quality reviews.

## **11. Evaluating the system of quality management – Periodic monitoring and objectivity**

SQMS No. 1 states that a peer review is not a substitute for all monitoring activities. The firm's quality management system should provide for internal inspection on a periodic basis. Since the objective of a peer review is similar to that of an inspection, the firm's quality management policies may provide that a peer review conducted under standards established by the AICPA may be a substitute for the inspection of engagement documentation, reports, and clients' financial statements for some or all engagements for the period covered by the peer review.

The internal inspection process should include a requirement to inspect completed engagements for engagement partners on a cyclical basis. The firm sets the criteria to identify the engagements and partners to be reviewed, as well as the frequency of such reviews. The competence and capabilities of the individuals performing the monitoring activities are paramount, as is providing them with sufficient time to perform the activities.

The standard also calls for the system to address the objectivity of the reviewer. The ASB included a provision in the exposure draft that would preclude people involved in the engagement from performing the inspection of that engagement. This was to mitigate the threat of self-review (because, as the AICPA phrased it in a commentary, “you don’t know what you don’t know”). This was removed from the final standard.

The final standard reiterates that objectivity is enhanced when the engagement team members and the EQ reviewer are not involved in performing any monitoring activities related to that engagement. However, it does not preclude those individuals from performing inspections. To lessen the threat of self-review and the risk that deficiencies may not be detected, the system could include the following safeguards:

- a. Fostering a commitment to continuing professional education and providing effective training programs so that personnel stay current on accounting, auditing, and quality management standards;
- b. Providing training on how to perform monitoring inspections and requiring the use of peer review or other inspection checklists; and
- c. Requiring a period of time after the completion of an engagement before self-inspections are performed.

## **D. SQMS No. 2 – Engagement quality reviews**

### ***1. Role of engagement quality review and other forms of review***

The engagement quality review (EQR) will, for many firms, be very important to the system of quality management. To address this in more detail, SQMS No. 2 was issued to explain the role of the EQ reviewer.

A firm’s EQR policy will vary depending on the complexity of the firm’s engagements. SQMS No. 2 states that there may be firms that do not require EQRs at all due to their types of engagements. An EQR may be required if:

- a. The engagement has a high level of estimation uncertainty;
- b. The engagement has a risk related to the entity’s ability to remain a going concern;
- c. The engagement has issues that have resulted in internal or external findings;
- d. The client has uncorrected significant deficiencies in internal control or material restatements;
- e. The engagement represents a must-select area; and
- f. Complex new accounting standards are being implemented by the client.

The firm’s policy should be drafted based on the circumstances of the specific firm. The firm should establish specific criteria to enable a consistent determination of the need for an EQR. In the original exposure draft, the engagement quality reviewer was not permitted to have been the engagement partner for the prior two years. This restriction was **not** retained in the final standard.

### ***2. Engagement quality reviewers***

SQMS No. 2 discusses the role of EQ reviewers and the characteristics necessary to fill the role as well as assist the EQ reviewer. Of particular note is the discussion that deals with the EQ reviewer’s required authority, competence, and capabilities. The standard highlights the need to provide sufficient time to

complete the engagement quality review. It also highlights that the engagement partner is required to obtain release from the EQ reviewer prior to report issuance.

In order for a person to serve as an EQ reviewer, they should:

- a. Not be a member of the engagement team;
- b. Have the appropriate authority, competence, and capability (including sufficient time) to perform the engagement quality review;
- c. Comply with relevant ethical requirements, including those addressing threats to the objectivity and independence of the EQ reviewer; and
- d. Comply with provisions of law and regulation, if any, that are relevant to the eligibility of the EQ reviewer.

SQMS No. 2 also outlines the nature and content of the EQR.

## **E. Test Yourself #1**

The AICPA had long focused on enhancing audit quality before it began the EAQ initiative. Over time, the technologies auditors use have changed, the standards have evolved, and clients have become more complex and global, yet audit quality remains a concern. What do you think is the biggest current threat to audit quality facing our profession over the next few years?

- A. The use of AI by auditing firms on audit engagements.
- B. The use of AI by our clients in preparing their financial statements.
- C. The need for standards to evolve as rapidly as the industry is changing.
- D. Personnel/staffing concerns.

There is no correct answer to this question.

## **F. Peer review**

### **1. Engagement and system reviews**

Every three years, a firm is required to undergo a peer review process. This will involve either an engagement review or a system review. Engagement reviews are available to firms that only perform SSARS engagements and review-level SSAE engagements or agreed-upon procedures. If a firm performs one or more of the following types of engagements, a system review is required:

- a. Engagements under the SASs;
- b. Engagements under the Yellow Book;
- c. Examinations under the SSAEs; or
- d. Audit or examination engagements under PCAOB standards.

A system review includes evaluation of a sample of the firm's engagements. A cross section of the firm's types of engagements and personnel are selected, including must-select engagements, the most significant of which are:

- a. Engagements performed under the Yellow Book;
- b. Audits of employee benefit plans;
- c. Audits of depository institutions (with assets of \$500 million or greater);
- d. Audits of broker-dealers; and
- e. Service and Organization Control (SOC) 1 and 2 engagements.

In conducting the peer review, the reviewer examines engagement workpaper files and reports. They will also interview certain firm personnel, obtain representations from the firm, and examine administrative and personnel files.

During the peer review, the reviewer may observe that the system of quality management is not properly designed or that it is properly designed but the firm is not complying with the requirements of the system. The term “nonconforming engagement” is used to describe an engagement that was not performed and/or reported on in conformity with applicable professional standards in all material respects.

Peer reviewers have a classification system that is used to identify circumstances noted during the peer review as matters, findings, deficiencies, or significant deficiencies. These are defined as follows:

- a. **Matter** – An instance where the peer reviewer identifies that the firm did not comply with one or more elements on the peer review checklist.

**Example:** A peer reviewer is using audit checklist 20,400 to evaluate a specific audit engagement in a system review. She reads question A124, “Did the auditor properly document compliance with fraud risk considerations?” Among the considerations identified in the question, the auditor is required to make fraud inquiries of management, those charged with governance, and others within the organization. The reviewer notes that although the auditor made inquiries of management and selected employees, they failed to interview anyone from the board of directors. The reviewer concludes that this was a matter for further consideration (MFC) and documents it on an MFC form.

- b. **Finding** – One or more related matters in the firm’s system of quality management, or compliance with it, such that there is more than a remote possibility that the reviewed firm would not perform or report in conformity with applicable professional standards. It is possible that the finding may not rise to the level of a deficiency or significant deficiency. However, the reviewer will document the finding on a finding for further consideration (FFC) form. They will look at similar findings in the aggregate when making a determination as to whether a finding is a deficiency or significant deficiency.

**Example:** A peer reviewer selects a sample of six audits for the peer review. In the first review, the auditor identified inherent risk and control risk for all the relevant assertions together. In addition, inherent risk was assessed as low for an account balance where the auditor identified it as a significant risk. In addition, the auditor identified control risk as moderate where the auditor had only concluded on the design of controls and whether they had been implemented. The reviewer is alert for the possibility that this is not an isolated occurrence in one engagement. At the conclusion of the review, he notes that this is a pattern in four of the six engagements. Based on discussions with the staff and engagement management, there was confusion among the teams as to the level of work that should be performed and documented for the risk assessment. The peer reviewer identifies the engagements as nonconforming since the issue is pervasive, and he completes an FFC form.

- c. **Deficiency** – A situation where due to the nature or systemic causes the firm would not have reasonable assurance of performing or reporting in conformity with applicable professional standards in one or more important respects. The distinction between a deficiency and a significant deficiency is that the peer reviewer has concluded that except for the deficiency the firm has reasonable assurance of performing and reporting in conformity with professional standards. This will lead to a report level of “pass with deficiencies” as discussed below.
- d. **Significant deficiency** – The reviewed firm’s system of quality management taken as a whole does not provide the reviewed firm with reasonable assurance of performing or reporting in conformity with applicable professional standards in all material respects. A significant deficiency leads to a report rating of “fail.”

Based on the work performed, the peer reviewer will issue a report. Ratings that a firm can receive are:

- a. **Pass** – The system is appropriately designed, and the firm complies with the system in all material respects.
- b. **Pass with deficiencies** – The system is designed, and the firm complies with the system in all material respects, except for certain areas that are explained in the peer review report.
- c. **Fail** – The peer reviewer has concluded that the firm’s system of quality management is not suitably designed, or the firm does not comply with the system as outlined in the report.

**Example:** In the example above, the peer reviewer identified the engagements as nonconforming for failure to properly assess inherent risk and control risk. There were no further matters or findings noted. Based on the pervasive issue, the FFC is identified as a deficiency and not a significant deficiency, leading to a peer review rating of pass with deficiencies.

If a deficiency or significant deficiency is related to an engagement in a must-select area or specific industry, the report will identify the area. However, generally since the system review is designed to report on the firm’s system of quality management, the report would not necessarily describe every engagement that was deemed nonconforming.

The firm is required to take corrective action and remediate engagement deficiencies and weaknesses identified in its system of quality management. The peer reviewer will evaluate the response to see if it is an indication of further issues in the quality management system and whether monitoring procedures are deemed necessary.

Firms that perform only accounting work, including reviews and compilations, choose an engagement review. The peer reviewer will select a sample of the work performed by the firm and evaluate whether the required procedures are performed and whether the firm’s reports that are issued are appropriate.

As with system reviews, the firm is required to make remediations as indicated by the report. Note that since an engagement review does not provide the reviewer with sufficient basis to express any form of assurance no opinion is expressed.

## 2. Recent peer review findings on accounting matters

The AICPA assists practitioners by providing the latest peer review findings so they can assess their quality and make improvements. As it relates to auditing, the most frequent peer review findings were related to risk assessment. The following table lists the top MFCs from the AICPA's reports on peer review MFCs released in 2024.

Area	Peer Review Finding(s)	Percentage of MFCs
ASC 606, revenue recognition	Failure to adopt and failure to include disclosures including the opening balance disclosures	30%
ASC 958, not-for-profits	Failure to adopt or correctly adopt accounting standards related to the presentation of financial statements, including functional expense reporting, liquidity and availability of resources, and inadequate disclosures related to donor-restricted assets and conditional contributions	12%
Statement of cash flows	Improper netting where gross presentation is required, misclassification between categories, failure to disclose cash paid for interest, and improper presentation of restricted cash balances and reconciliation to balance sheet	9%
Debt	Omission of required debt disclosures, absence of five-year debt maturity schedule, and improper classification	5%
Balance sheet	Issues with various accounting policy disclosures, including basis for inventory valuation and those related to allowance for doubtful accounts	4%
Subsequent events	Disclosure failures related to subsequent events	4%
Fair value	Issues with fair value leveling table	3%
Leases	Failure to adopt FASB ASC 842 where required and failure to include numerous disclosures required by FASB ASC 842 (note: FASB ASC 842 was NOT effective for some engagements reviewed in 2023, including fiscal year-ends and other engagements in process during the peer review where a prior year engagement may have been selected)	3%
Income taxes	Display of current amount when noncurrent classification is required and failure to present net amounts when required	3%

## G. Ramifications of inadequate supervision and review

The AICPA was concerned that peer reviewers were not adequately performing their work, which, in turn, caused deficiencies within a firm's system of quality management. To correct this issue, the AICPA started a robust program for peer review oversight. From its EAQ reports, it appears that this is working.

Firm personnel that review workpapers need to be aware of the ramifications of not performing a thorough job in workpaper review. Peer reviewers recommend remediation for firms with nonconforming engagements such as preissuance review and additional targeted continuing professional education (CPE). The statistics from prior studies show that 77 percent of firms improved after CPE, 86 percent improved after a third-party review of engagements or quality management documents and 90 percent

improved after preissuance reviews of firm engagements. If firms fail to remediate after their second consecutive non-pass peer review, they can be terminated from the peer review program.

## H. AICPA focus areas

The AICPA collects and uses data to analyze nonconformities. **Risk assessment** is at the top of the list of its focus areas. The 2026 EAQ report provided the following insights into the AICPA’s activities in connection with its quality initiative.

Recent AICPA EAQ focus areas include risk assessment, quality management, technology-enabled auditing, single audits, and emerging engagements.

### ***Focus point for workpaper reviewers:***

Reviewers should be alert for changes to accounting and auditing literature. Recently the FASB has issued several significant pronouncements related to current and expected credit losses (CECL), leases, and income taxes. There have also been significant changes to not-for-profit accounting and reporting. Auditing standards have been amended significantly with 15 pronouncements issued between 2019 and 2023. Failure to keep up with professional standards can cause a reviewer to miss an important audit step or disclosure as illustrated below.

## I. Changes to auditing standards

The chart below identifies issues for the workpaper reviewer at the in-charge or manager level to consider.

Audit Standard	Main Provisions	Potential Impact on Workpaper Review
SAS No. 134	Modifies the form and content of the auditor’s report. The amendment addresses the auditor’s responsibility to form an opinion on the financial statements. This amendment includes the auditor’s report, modifications to the opinion and emphasis of matter paragraphs.	Reviewers are responsible for the first level review of the report with the partner making the final review. If the language is not consistent with professional standards the report will be deficient. In addition, engagement letters and representation letters are often affected by changes in audit literature. The workpaper reviewer should proof the communications to professional practice aids or the audit standard to ensure that they are revised appropriately. <b>This does not appear to be as big an issue as omitting the consideration in the communications to governance related to significant risks.</b>
SAS No. 135	Amends AU-C §260, <i>Communications with those Charged with Governance</i> ; AU-C §550, <i>Related Parties</i> ; and AU-C §240, <i>Consideration of Fraud in a Financial Statement Audit</i> .	The workpaper reviewer will find that there are new procedures and inquiries required by these standards. Many times, nonsupervisory staff and less experienced supervisory staff use the “same as last year” approach (SALY). When this happens, they may fail to perform important procedures and may even sign off on steps not performed through lack of reading the audit program carefully.

Audit Standard	Main Provisions	Potential Impact on Workpaper Review
SAS No. 136	<p>Addresses the auditor's responsibility to form an opinion and reporting on financial statements of employee benefit plans subject to ERISA. It also adds new requirements for:</p> <ul style="list-style-type: none"> <li>• Engagement acceptance</li> <li>• Audit risk assessment and response;</li> <li>• Communications with those charged with governance;</li> <li>• Procedures for an ERISA §103(a)(3)(C) audit; and</li> <li>• Considerations related to Form 5500.</li> </ul>	<p>This standard represents the most significant change to employee benefit plan (EBP) literature since prior to SAS No. 136 it only existed in an audit guide. SAS No. 136 adds new procedures as noted in this chart. Reviewers of EBP engagements should be careful to ensure that standards are followed. The engagement letters and representation letters include new language so proofing them against new practice aids and professional standards is important.</p>
SAS No. 137	<p>Addresses the auditor's responsibilities relating to other information included in annual reports.</p>	<p>Should this be applicable, the reviewer will want to ensure that the appropriate communications are made with the client and procedures performed, as necessary.</p>
SAS No. 138	<p>Changes the definition of materiality.</p>	<p>This should not cause many issues for the workpaper reviewer, but they should ensure that report, engagement letter, and perhaps representation letter language conforms.</p>
SAS Nos. 139/140	<p>Addresses changes for special purpose frameworks and supplemental information.</p>	<p>The reviewer should ensure report, engagement, and representation letter language conforms.</p>
SAS No. 142	<p>Addresses emerging technologies being used by preparers of financial statements and auditors, data analytics, professional skepticism, and the use of external information as audit evidence and assessment of its reliability, completeness, and accuracy.</p>	<p>The workpaper reviewer will need to ensure that the workpapers include consideration of newer technologies and the reliability, completeness, and accuracy of data used, as well as the appropriateness of techniques used by the team in testing.</p>
SAS No. 143	<p>Addresses audit estimates. The standard:</p> <ul style="list-style-type: none"> <li>• Requires a separate evaluation for inherent risk and control risk for estimates;</li> <li>• Proposes additional risk assessment procedures for estimates; and</li> <li>• Emphasizes that internal controls over the development of accounting estimates are important. Lack of internal controls over significant estimates with high estimation risk could be a material weakness or significant deficiency.</li> </ul>	<p>Reviewers are responsible for the first level review of the report with the partner making the final review. If the language is not consistent with professional standards the report will be deficient. In addition, engagement letters and representation letters are often affected by changes in audit literature. The workpaper reviewer should proof the communications to professional practice aids or the audit standard to ensure that they are revised appropriately.</p>

Audit Standard	Main Provisions	Potential Impact on Workpaper Review
SAS No. 144	<p>Addresses guidance related to general use of a specialist and use of pricing information from third parties. The standard:</p> <ul style="list-style-type: none"> <li>• Enhances guidance about evaluating the work of the management’s specialist; and</li> <li>• Provides guidance on the use of pricing information as audit evidence for estimates related to the fair value of financial instruments.</li> </ul>	<p>The reviewer will need to ensure the auditor:</p> <ul style="list-style-type: none"> <li>• Evaluated the competence, capabilities, and objectivity of that specialist;</li> <li>• Obtained an understanding of the work of that specialist; and</li> <li>• Evaluated the appropriateness of that specialist’s work as audit evidence for the relevant assertion.</li> </ul> <p>With respect to pricing information, the reviewer will need to make sure the auditor assessed the relevance and reliability of the information and considered factors such as the experience and expertise of the pricing service, the methodology utilized, and whether the pricing service has any bias towards or relationships with management that would allow management to influence the pricing service.</p>
AU-C §315	<p>Enhances requirements and guidance related to obtaining an understanding of the entity’s system of internal control and assessing control risk. The standard provides guidance that addresses the economic, technological, and regulatory aspects of the markets and environment in which entities and audit firms operate.</p>	<p>The workpaper reviewer should ensure that the auditor:</p> <ul style="list-style-type: none"> <li>• Evaluated the design of the system of internal controls (including IT general controls) and determined whether the controls have been implemented;</li> <li>• Determined whether control risk and inherent risk were separately assessed;</li> <li>• Assessed RMM equal to inherent risk (and control risk was assessed at high) when the operational effectiveness of controls was not tested;</li> <li>• Assessed the completeness of the auditor’s identification of significant classes of transactions, account balances, and disclosures (stand-back requirement);</li> <li>• Properly met audit documentation standards;</li> <li>• Performed audit procedures appropriate to the scalability of the entity under audit; and</li> <li>• Maintained professional skepticism.</li> </ul>

Audit Standard	Main Provisions	Potential Impact on Workpaper Review
SAS No. 146	Seeks to: <ul style="list-style-type: none"> <li>• Increase firm leadership responsibilities and accountability and improve firm governance;</li> <li>• Introduce a risk-based approach focused on achieving quality objectives;</li> <li>• Address technology, networks, and the use of external service providers;</li> <li>• Increase focus on the continual flow of information and appropriate communication internally and externally;</li> <li>• Promote proactive monitoring of quality management systems and timely and effective remediation of deficiencies;</li> <li>• Clarify and strengthen requirements for more robust EQRs; and</li> <li>• Enhance the engagement partner's responsibility for audit engagement leadership and audit quality.</li> </ul>	This standard is intended to create higher quality standards and practices from the top of the organization down with more robust policies and procedures introduced at the firm leadership level and executed throughout the audit process.
SAS No. 147	Introduces narrow guidance related to predecessor auditor procedures. Requires: <ul style="list-style-type: none"> <li>• The auditor to request management permission to speak with predecessors;</li> <li>• The auditor to inquire about identified and suspected fraud and matters involving NOCLARs;</li> <li>• The predecessor to respond timely and clearly;</li> <li>• The auditor to evaluate predecessor's response;</li> <li>• The auditor to document the inquiries and the result of those inquiries once engagement is accepted; and</li> <li>• The auditor to inquire why if management does not provide permission to speak with predecessors and determine whether that prevents the auditor from accepting the engagement.</li> </ul>	The reviewer of workpapers should ensure that this standard is met both in terms of performing the procedures and in documenting them when taking over a client from a predecessor auditor.
SAS No. 148	Addresses conforming changes to compliance audits.	Workpaper reviewers of compliance audits will need to make sure the conforming updates are implemented in compliance audits.
SAS No. 149	Updates guidance on performing group audits by directing the group auditor to use professional judgment in determining components to perform procedures.	Reviewers of workpapers should ensure that the auditor documents what judgments were made in determining significant components, what information was used, and how components were selected.

## J. Test Yourself #2

Which of the following statements is true about professional standards on accounting and auditing?

- A. The reviewer should take care when reviewing the auditor's report, engagement letters, representation letters, and other communications, since professional standards may change the language.
- B. The FASB's standards are not as important to the reviewer as the AICPA's standards.
- C. As long as staff follow the prior year's workpapers, the engagement will pass peer review.
- D. Only auditors of public companies need to worry about these standards.

## III. Audit documentation

Audit documentation has always been a major cited reason for nonconforming audits. Although the preparer of the workpaper has primary responsibility for the quality of documentation, the fact is that nonsupervisory auditors are learning, and it is the reviewer's responsibility to provide guidance to them. The initial review, sometimes referred to as detail review or the first level review, is the place where issues need to be raised and errors and omissions corrected. Once the workpapers have gone through an initial review, later reviews are not as comprehensive.

### ***Focus point for workpaper reviewers:***

Some auditors may perform an audit step and – rather than take the time to write comments about the actions taken and results of the step – document the work with a tick mark or checkmark on a practice aid. This may not be sufficient to comply with professional standards. In some cases, the auditor may not even be aware that they have not performed the level of work required by professional standards.

### A. General standards on documentation

AU-C §230, *Audit Documentation*, discusses the general standards of documentation but be aware that each individual set of standards, (e.g., audit, review, compilation, or attestation) also contains its own requirements for documentation. In addition, certain laws, regulations, and other standards may impose additional regulations on the practitioner. Finally, individual standards on topics such as risk assessment, performing procedures, auditor's consideration of fraud and going concern, among others, contain additional documentation requirements.

### ***Focus point for workpaper reviewers:***

The workpaper reviewer should ensure that all documentation standards are followed. The easiest way to do this is through the use of practice aids from a reputable vendor such as CCH (Knowledge Coach), Thompson Reuters (PPC), and others. These peer-reviewed practice aids provide an updated and comprehensive list of the procedures required by professional standards. If an auditor chooses not to use a practice aid and instead relies on firm-created aids, it is important that they are updated every year.

According to AU-C §230, the auditor should 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 GAAS 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 conclusion reached, and significant professional judgments made in reaching the conclusions.

When preparing documentation, the auditor should document:

- a. The identifying characteristics of the specific items tested;
- b. The person who performed the work and the date the work was performed; and
- c. The person who reviewed the work performed, the date, and the extent of review.

When documenting the nature, timing, and extent of audit procedures, the auditor will consider sampling applications. Sampling applications are used when testing attributes such as the occurrence of an internal control and in identifying the extent of items to test in substantive testing. AU-C §530 provides guidance on sampling methodologies used in an audit including documentation requirements. These are discussed in another module.

## **B. Mandatory and presumptively mandatory requirements**

Auditing standards contain requirements with which the auditor **must** comply. These are unconditional standards. There are very few instances in professional literature where the auditor **must** comply. Most of the standards state that the auditor should do one thing or another. The word “should” refers to a presumptively mandatory requirement, and if the auditor decides to depart from the standard, they should document the justification for the departure.

## **C. Exercise 1 – Presumptively mandatory requirements**

Professional standards require that accounts receivable be confirmed. The audit partner on the engagement knew that in situations involving nursing home patients, the chances of confirmations being returned were very low. Therefore, he directed the staff to test subsequent payments instead. The workpaper contained a list of the patients selected for testing along with a record of payments vouched and a summary at the bottom showing the extent of the testing performed and the results. Was this documentation sufficient to meet professional standards?

## **D. General matters arising after the date of the auditor’s report**

There may be times when an auditor identifies an issue after the audit report has been issued and is required to go back and perform procedures to address it. This is not simply a matter of cleaning up audit documentation but where the auditor goes back and performs additional work or draws new conclusions.

The auditor should document:

- a. The circumstances encountered;
- b. New or additional procedures performed, evidence obtained, and conclusions reached as well as their effect on the auditor’s report; and
- c. The timing of the work and the person who made and reviewed the changes made to the workpapers.

**Example:** An audit firm issues its report on Lazy Days Pet Lodge on December 31, 20X2. Three months later, a new controller is hired and notifies the audit partner of a significant liability that had not been recorded at year-end. It is unclear to the new controller whether the invoice had been deliberately concealed or simply overlooked. The auditor is concerned and sends a staff person out to the field to perform another search for unrecorded liabilities to see if this was an isolated instance or if the former controller was concealing evidence to improve the company’s bottom line.

No other significant instances are found, and the auditor concludes that the financial statements would not have been materially misstated. However, since the company is an acquisition target, the board wants to make the adjustment. The auditor documents the circumstances, the reason for the additional work performed, the results of the procedures performed, and the audit adjustment to the 20X2 financial statements. He reissues the financial statements.

## **E. Assembly and retention of the final audit file**

The auditor should document the report release date in the audit documentation. The **report release** date, which is defined in AU-C §230, is the date when the entity delivers the audit report to the entity. AU-C §700 states that the auditor's report should be dated no earlier than the date when the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements, including evidence that the audit documentation has been reviewed, all the statements that the financial statements including the related notes, have been prepared and management has asserted that they have taken responsibility for those financial statements. Documentation should be prepared to support these activities.

The auditor should perform subsequent event procedures so that they cover the period from the date of the financial statements to the date of the auditor's report or as near as possible. Although the standards do not present an acceptable timeframe it is best practice to ensure that the report release date is as close as possible to the financial statement date since this helps to minimize the possibility of having to reopen the audit to address events that may come to light after the financial statements have been issued. In addition, the FASB requires management to disclose the date through which the entity has evaluated subsequent events noting whether the date is when the financial statements were issued or were available to be issued.

AICPA auditing standards provide a 60-day window where the auditor has time to assemble the documentation in the audit file and complete any further administrative tasks related to the file. These items might include ensuring signoffs are present, adding originals of confirmations that might have been received electronically prior to report release and clarify information in the file. Note that for audits performed under PCAOB standards, the audit files must be archived in 14 days.

The date at which the documentation is complete and the file ready to be locked down is called the **documentation completion date**. After that time, the auditor cannot delete or discard audit documentation before the end of the record retention period. This retention period can be no shorter than five years from the report release date (seven years for PCAOB audits). Auditors should be aware that some states and regulators could have a shorter window. The PCAOB's documentation window is 14 days (down from 45 previously). The standards require that the firm have controls in place to ensure documentation is not altered or deleted. They also require policies and procedures related to protection of the information, especially if it is transmitted electronically as well as client confidentiality.

Most firms use software products that simplify the documentation completion process. These features are very helpful and can assist the firm in its documentation to meet quality management standards.

## F. Test Yourself #3

Under AICPA Auditing Standards, how long after the issuance of the report is the auditor permitted to make administrative changes to the workpapers?

- A. 30 days.
- B. 60 days.
- C. 90 days.
- D. 120 days.

## G. Categories of workpapers and workpaper reviewer focus points

The workpaper reviewer will be responsible for reviewing areas where they have the knowledge and experience to do so. The types of workpapers reviewed fall into four categories: planning (including risk assessment), internal control, substantive testing, and concluding and reporting.

The following table presents the workpaper review issues that frequently surface in internal inspections and peer reviews of which the **in-charge or manager** should be aware. Note that a senior manager often performs work at a partner level in some firms. This module does not address that level of workpaper review.

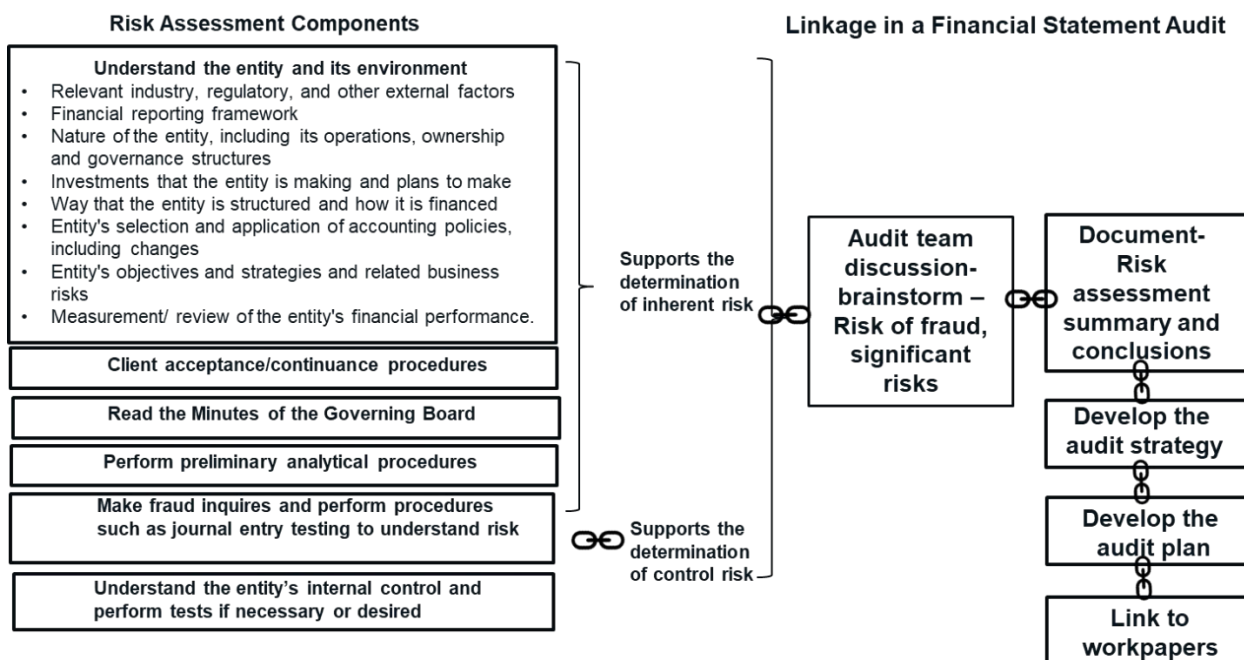
### 1. Planning including risk assessment

Procedure	Form of Documentation	Focus Point for the Workpaper Reviewer
Client acceptance and continuance, AU-C §210	Generally a practice aid	The workpaper reviewer is not likely to be involved in this process as this task is typically performed at the partner level.
Issuance of engagement letter, AU-C §210	Letter on firm letterhead	The workpaper reviewer will want to ensure that the language in the letter meets current professional standards. In addition it is important to ensure that any nonattest services are clearly identified and the appropriate language on management's responsibility is included.
Materiality, AU-C §320	Typically a practice aid	Reviewers should review this workpaper closely and then keep the following in mind during the audit to ensure that sufficient testing is performed: tolerable misstatements (specifically in sampling applications) and trivial misstatements, or the amounts that if identified in reconciliations or in clerical errors made by the client, the auditor can pass within the workpapers. Often an amount is set as trivial and then not followed during the audit resulting in adjustments that should have been posted to the trial balance or to the summary of passed adjustments.

Procedure	Form of Documentation	Focus Point for the Workpaper Reviewer
Understanding the entity and its environment, AU-C §315	Could be a practice aid or a memo	<p>This is an important area that is not always properly documented by the engagement team. Peer reviewers have noted that this workpaper, which is usually documented in the form of a memo or on a practice aid, is carried over without modification. In addition, references in the carryforward workpaper referring to superseded standards make it appear that the auditor is not updating it.</p> <p>Workpaper reviewers also need to watch for the “smoking gun.” This is where the preparer includes phrases such as “we will follow up” or “this could be a risk.” If the preparer has, indeed, identified a risk then it should be addressed in the team discussion. The reviewer will want to ensure that the linkage is there. If not, it should be resolved on the workpaper where it originated, or the preparer should delete it. Linkage is a big problem identified by peer reviewers.</p>
Performing preliminary analytical procedures, AU-C §315	Typically an Excel worksheet	The reviewer should take care to ensure that preliminary analytical procedures contain an expectation. This is an important requirement. In addition, the reviewer should counsel preparers if the expectations are too vague (we expect revenue to increase). Reviewers should also watch for instances where the items that are investigated are only where there is a variance above scope. Often, it is the variance that is not there that could give rise to fraud. Clients could hold a balance relatively constant to avoid questions.
Consideration of fraud, AU-C §240	Typically a memo summary or practice aid	The reviewer will want to ensure that the team makes inquiries of those charged with governance, if any. Frequently, this important step is omitted. Questionnaires may not provide sufficient evidence, especially if the answers are “yes or no” as opposed to documentation of the interviewee’s thought processes. Face to face interviews that are in person or via Zoom, even phone discussions are preferable. The findings from these discussions, if any, should be carried to the team discussion for proper linkage.
Team discussion (brainstorming), AU-C §315	Typically a memo	There are numerous elements required by professional standards to be discussed. The team discussion should be documented by more than just practice aids with discussion points or an agenda. It is important to see the conclusions reached by the audit team. The partner should be involved in this discussion. Reviewers should ensure that the documentation is complete.
Performing the risk assessment – Evaluating inherent risk, control risk, significant risk, risk of fraud, AU-C §315	Typically a practice aid	<p>With the issuance of AU-C §315, professional standards specifically require that risk be assessed at the assertion and financial statement level, and that inherent and control risk be assessed separately. The AICPA requires documentation related to the assessment of inherent risk as high, moderate, or low.</p> <p>Professional standards state that it would be rare that there are no significant risks identified. Reviewers should challenge instances where no significant risks are identified and also ensure that management override is identified as a significant risk as is revenue recognition (unless the team documents why it is not).</p> <p>Risks should be linked to the audit plan.</p>

Procedure	Form of Documentation	Focus Point for the Workpaper Reviewer
Preparing the audit strategy, AU-C §300	Often documented in places that already contain the information rather than in one place	The reviewer should ensure that all required elements are documented including noting on a summary practice aid if there is no one specific place where the documentation can be found. In that case the reviewer should ensure that cross references to the engagement letter and other memos and practice aids link appropriately.
Preparing the audit plan, AU-C §300	Typically generated by firm software based on responses or practice aids used	The reviewer should ensure that the audit programs are responsive to the level of risk identified in the risk assessment summary including significant risks and risks of fraud. Where commercial audit programs do not address an important step, the reviewer should ensure that the step is added.  The reviewer should ensure that the references on the audit program link directly to the appropriate workpaper.

The diagram below illustrates the important links in the risk assessment process. Reviewers may want to study this diagram.



The audit is an iterative process. It's not over until it's over!

## 2. Internal control

Procedure	Form of Documentation	Focus Point for the Workpaper Reviewer
<p>Understanding internal control, AU-C §315</p>	<p>Generally a Word or Excel document. The client may prepare narratives to aid in documentation</p>	<p>The reviewer will want to ensure that the auditor obtains an understanding of the entity level controls as well as the control activities.</p> <p>Professional standards say that inquiry alone is not sufficient to obtain the understanding of whether the controls have been implemented.</p> <p>It is important for the reviewer to ensure that there is documentation to support the design of controls. This is often overlooked by auditors when commercial practice aids are not used. This is significant because a control that has been implemented will not be effective if it is not properly designed.</p> <p>When the workpaper preparer evaluates entity level controls such as the control environment, risk assessment process, information and communication and monitoring they should not only identify the control but discuss why they believe it has been implemented. Otherwise, it appears to be a conclusion drawn by assuming that if the control is identified by management, it is implemented.</p> <p>With control activities, it is important to review the activities with an eye toward whether or not they are considered controls. Often, staff confuse tracing data from one point to another (e.g., pay rates tying to journals) with controls. With controls, the client personnel are taking an action. Otherwise, the procedure is a substantive or compliance test.</p> <p>Any deficiencies in internal control that are identified should be accumulated on a workpaper to evaluate to determine if they are significant deficiencies, material weaknesses, or just deficiencies. Those that are not required to be included in a communication in writing should be discussed with management. The reviewer should ensure that all deficiencies in the internal control workpapers or elsewhere in the engagement receive this treatment.</p> <p><b>Professional standards have changed. Design and implementation (D&amp;I) testing is only required for five types of controls (controls that address significant risks, address risks where the auditor believes substantive testing alone is not sufficient, support journal entries, will be tested for control reliance, and enable the auditor to assess the risks of material misstatement and design further audit procedures). Otherwise, unless the auditor wishes to test controls, an understanding of controls is adequate.</b></p>

### 3. Substantive testing

Procedure	Form of Documentation	Focus Point for the Workpaper Reviewer
Baseline information	Generally performed on the auditor-prepared lead sheet	<p>The reviewer should ensure that the beginning balances agree to the prior year financial statements and that the ending balances agree to the trial balance/general ledger.</p> <p>For every lead sheet, the reviewer should scan to see that all significant balances are tied to the place where work performed, and the linkage is appropriate.</p>
Detail testing	Generally on an Excel workpaper	<p>The reviewer should ensure that the details of account balances that are tested tie to the balance on the lead sheet and if not, that there is a reconciliation performed between the two. The reviewer should ensure that the reconciling items, if significant, are tested.</p> <p>The reviewer should ensure that sample sizes are properly documented. Sampling forms in commercial practice aids are the best practice here.</p> <p>There are times when a preparer will put client journals and ledgers in the file. This is easy to do with today's electronic workpapers. It is not good practice to document the work performed on a sample of, for example, 25 items in a journal spanning a hundred pages. This means that the reviewer has to go through the journal hunting for the work. It is better to schedule out the selections on a Word or Excel workpaper.</p> <p>The reviewer will want to ensure that any items marked NA in a sampling application are replaced.</p> <p>The reviewer will want to ensure that any errors or reconciling items over trivial are either proposed as journal entries or passed to the summary of passed adjustments.</p> <p>The reviewer will want to ensure that any statements made by the preparer that sound as if there is additional risk are evaluated, discussed with engagement management and the disposition documented.</p> <p>The reviewer will want to ensure that the workpapers are clear and concise and free from contradictory comments.</p>

### 4. Concluding – Subsequent events

The auditor is required to update subsequent events near the end of the audit. This is a very important step in concluding the audit and one that should be taken seriously. Management will include a footnote in their financial statements that states the date through which they have evaluated subsequent events. This is the date that the financial statements are issued or available to be issued. The following definitions are included in the glossary to AU-C §560, *Subsequent Events and Subsequently Discovered Facts*.

AU-C §560 provides the following definitions:

- a. **Subsequent events** – Events occurring between the date of the financial statements and the date of the auditor's report.
- b. **Subsequently discovered facts** – Facts that become known to the auditor after the date of the auditor's report that, had they been known to the auditor at that date, may have caused the auditor to revise the auditor's report.

When the auditor evaluates subsequent events, they will perform certain procedures that cover up to as close to the date of the financial statements as practicable. The auditor should consider the results of the risk assessment in determining the nature and extent of procedures. They should include the following:

- a. Obtain an understanding of any procedures that management has established to ensure that subsequent events are identified;
- b. Inquire of management and, when appropriate, those charged with governance about whether any subsequent events have occurred that might affect the financial statements;
- c. Read minutes, if any, of the meetings of the entity's owners, management, and those charged with governance that have been held after the date of the financial statements and inquiring about matters discussed at meetings for which minutes are not yet available; and
- d. Read the entity's latest subsequent interim financial statements, if any.

As noted earlier, it may be necessary to contact attorneys where the legal letter was received significantly before the end of the audit and there is pending or threatened litigation that could have a material effect on the financial statements.

If the auditor identifies subsequent events that require adjustment of, or disclosure in the financial statements, they should determine whether the event is appropriately reflected in the financial statements in accordance with the applicable financial reporting framework (or disclosure is needed for fair presentation).

Subsequent events are characterized as either type 1 or type 2 based on the circumstances as outlined in the FASB's ASC 855.

Type	Description	Accounting and Disclosure Requirements
Type 1 Event	Event provides evidence of conditions that existed at the date of the financial statements	Management is required to <b>recognize</b> the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet in the financial statements. This includes the estimates inherent in the process of preparing financial statements. Whether the event meets or does not meet the requirements for recognition, it should be disclosed, if material.
Type 2 Event	Event provides evidence of conditions that arose after the date of the financial statements	Management should <b>not</b> recognize subsequent events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after the balance sheet date but before financial statements are issued or are available to be issued.  Note that some nonrecognized subsequent events may need to be disclosed to keep the financial statements from being misleading. For these events, management should disclose the nature of the event and an estimate of its financial effect, or a statement that such an estimate cannot be made.

Subsequent events may impact the dating of the auditor’s report in various ways:

- a. If financial statements are adjusted before report release, the auditor’s report would be dated as of the date the auditor obtained sufficient appropriate audit evidence to support the opinion, including the subsequent event.
- b. Sometimes a report will be held open and not released in order to identify sufficient information about a subsequent event to be clarified. This may mean that the original report date is “pushed back” because of matters that came to the auditor’s attention after fieldwork but prior to report release.
- c. If financial statements are adjusted with additional footnote disclosure, the auditor’s report should either be:
  - (i) Dual dated with the original report date and the later date prior to report release when sufficient appropriate evidence was gained related to the subsequent event; or
  - (ii) Dated as of the date that sufficient appropriate evidence was gathered relating to the subsequent event. If the auditor dates the report as of the date of the subsequent event, they should extend the subsequent events review and other general audit procedures through the new audit report date.
- d. If the client refuses to make necessary material financial statements adjustments and/or disclosures of known subsequent events prior to report release, the auditor should modify their audit opinion with a qualified opinion or express an adverse opinion if needed.

## 5. Reporting

Procedure	Form of Documentation	Focus Point for the Workpaper Reviewer
Report	Word document	The reviewer should ensure the language in the auditor’s report including any emphasis of matter paragraphs or opinions on supplementary information have the current appropriate wording. Peer reviewers have noted that sometimes the opinions are carried over from one client to another changing the client name. The reviewer should make sure that the name of the individual financial statements is what is on the statement titles.
Financial statements	Word document and disclosure checklist	The reviewer should use a disclosure checklist to ensure that all of the required elements of the financial statements are included and that the notes meet professional standards including those for fair presentation.
Governance communications, AU-C §260	Word document	The reviewer should ensure that the required elements are in the governance communication.

## 6. Wrap-up – Additional focus points for the workpaper reviewer

The workpaper reviewer should be sure to:

- a. Determine whether there are any unanswered questions and ensure that the workpapers contain sufficient appropriate evidence to support the work performed, conclusions reached, and audit opinion;
- b. Eliminate unwarranted, unsupported, contradictory, or other inappropriate comments;
- c. Determine whether the audit was both effective and efficient, being alert for future improvement opportunities (note that it may be a good idea to keep these notes in a file other than the workpaper files); and
- d. Ensure all review notes are cleared satisfactorily.

## H. Test Yourself #4

Which of the following is NOT true regarding workpaper review?

- A. The reviewer is responsible for tying account balances back to the general ledger and prior year workpapers and ensuring that the detail tested by the workpaper preparer agrees with the account balance for the current year or is reconciled to it.
- B. The reviewer is responsible for ensuring that there is appropriate linkage from planning workpapers to the risk assessment and from the risk assessment to the substantive testing performed.
- C. The reviewer is responsible for ensuring that internal controls are always tested.
- D. The reviewer is responsible for ensuring that the audit programs have been signed off up to their level of responsibility.

## I. Exercise 2 – Preliminary analytical procedures

An audit firm is auditing a light manufacturing company. The staff have prepared a workpaper on preliminary analytical procedures. You are in the in-charge workpaper reviewer. What might your comments be on this workpaper? Provide suggestions on how it might be improved.

### Precision Parts Inc.

#### Preliminary Analytical Review

Years ended December 31, 20X9 and 20X8

**Expectation:** We believe that sales will go up a small amount based on talking to the client personnel in sales. The entity raised its prices 5 percent pretty much across the board. Operating expenses ought to stay the same.

Statements of Operations				
	20X9	20X8	\$ Change 20X9-20X8	% Change 20X9-20X8
Revenue:				
Product Sales	\$184,327	\$174,814	\$9,513	5.44%
Service contracts	289,275	337,483	-48,208	-14.28%
Investment income	8,275	7,806	469	6.01%
Total revenue	481,877	520,103	-38,226	-7.35%
Expenses:				
Payroll and benefits	238,406	254,873	-16,467	-6.46%
Cost of product sold	145,395	150,021	-4,626	-3.08%
Administrative expenses	58,652	51,459	7,193	13.98%
Total expenses	442,453	456,353	-13,900	-3.05%
Pretax income	39,424	63,750	-24,326	-4%
Income tax expense	-14,530	-16,550	2,020	-12.21%
Net income	24,233	47,200	-22,967	-48.66%

this looks like it is reasonable  
I wonder why this decreased so much. Let's look into it.

Supplemental analytics - Revenue					
Product Sales	\$184,327	\$174,814	\$9,513	5.44%	The margin looks high on this in the current year.
Cost of product sold	-145,395	-150,021	4,626	-3.08%	
Margin	38,932	24,793	14,139	57.03%	
Margin %	21%	14%			
Service contracts	\$289,275	\$337,483	-48,208	-14.28%	
Number of customers served	175	205	-30	-14.63%	
Average Revenue per contract	\$1,653	\$1,646	7	0.41%	

	20X9	20X8	\$ Change 20X9-20X8	% Change 20X9-20X8	
<u>Assets</u>					
Current assets:					
Cash and cash equivalents	\$312,833	\$469,633	(156,800)	-33.39%	
Accounts receivable	212,625	21,000	191,625	912.50%	We will perform subsequent collection analysis here
Related party receivable	2,953	3,542	-589	-16.63%	
Prepaid expenses	55,000	50,162	4,838	9.64%	
Other assets	19,633	310	19,323	6233.23%	Better look into this one
Total current assets	603,044	544,647	58,397	10.72%	
Property and equipment:					
Office furniture, equipment and software	179,039	172,394	6,645	3.85%	We will vouch the additions
Less accumulated depreciation	93,101	86,103	6,998	8.13%	
Property and equipment, net	85,938	86,291	(353.00)	-0.41%	
Other assets:					
Investments	53,456	48,452	5,004	10.33%	
Total other assets	53,456	48,452	5,004	10.33%	
TOTAL ASSETS	\$742,438	\$679,390	\$63,048	9.28%	

<u>Liabilities and Retained Earnings</u>					
Current liabilities:					
Accounts payable					
Trade	\$40,546	\$69,545	-28,999	-41.70%	accounts payable never stay the same
Other	8,505	8,897	-392	-4.41%	
Accrued payroll and payroll related liabilities	91,856	\$69,899	21,957	31.41%	
Deferred revenue	53,508	45,279	8,229	18.17%	
Total current liabilities	194,415	193,620	795	0.41%	
Notes Payable	398,258	360,238	38,020	10.55%	This is a normal debt payment
Total Liabilities	592,673	553,858	38,815	7.01%	
Common Stock	1,000	1,000	-	0.00%	
Retained earnings	148,765	124,532	24,233	19.46%	
Total Shareholder's Equity	149,765	125,532	24,233	19.30%	
TOTAL LIABILITIES AND SHAREHOLDER'S EQUITY	\$742,438	\$679,390	\$63,048	-	

## IV. Working with staff

### A. Orientation to the engagement

The in-charge or manager reviewer will want to perform some preliminary due diligence related to the engagement before interacting with staff. It sets a good tone if the in-charge has sufficient knowledge about the entity and its environment, including internal controls. If the client is new to the firm, then this may not be possible. However, the in-charge should become familiar with the industry, performing some research on news related to the client.

On recurring engagements, the in-charge should:

- a. Read all correspondence with the client;
- b. Review the prior year financial statements and any current year summarized draft financial information;
- c. Read any prior year internal control communications and governance communications;
- d. Scan the current year trail balance and any identified adjusting journal entries provided by the client;
- e. Compare significant account balances with the prior year and identify significant fluctuations. If the entity has covenants, evaluate those and any ratios with prior year; and
- f. Ask for new leases, loans, and other permanent file documents and review them.

## **B. Reducing review notes through proper preparation**

Many review notes can be avoided with proper planning and supervision. It is helpful to meet with the staff on the engagement and provide them with guidance right from the start. Stress the need to ask questions but at the same time encourage the staff to do some independent research and come to any meetings with some ideas. Spoon-feeding information to staff may make them dependent.

The in-charge should provide input and feedback on the design of the audit plan linked to the engagement team's assessment of risk. Staff should advise on the need to follow professional standards and if there are elements of the audit plan that they do not understand, it should be brought to the in-charge's attention rather than ignored.

Staff people are learning. Reviewers should understand that staff people, especially those that are newer to auditing, need to be comfortable with both the "how" and "why" when assigned audit areas, including the reason for changes from the prior year audit approach. The people in charge will have more productive staff if the staff feel like their ideas are important. In fact, staff may provide good insight into possibilities for more efficient and effective audits since they are working directly on a particular area.

It is important to encourage staff to ask for help when needed. There may be times when talking to a client when the staff do not understand the client's answers to questions. This could be that the client personnel are not communicating clearly, that client personnel may not have an answer but won't say so or that the client is covering something up. Conversely it may be that the staff simply is not experienced enough. Either way, the in-charge can support and empower staff by sitting in on a discussion. It is important for the staff to feel supported in this way or they may just document what the client says and move on, perhaps damaging audit quality and impairing their chance to learn.

It is also good to hold status meetings with the entire staff to identify any issues of staff spinning their wheels and not completing areas during the assigned time frame. It also helps to plan the work that needs to still be completed. Status meetings can curb the inclination some audit staff may have to over audit or investigate immaterial items.

Sometimes the in-charge auditor is onsite with the staff and sometimes they are not. In addition, audits these days, even before the pandemic can be virtual with staff in one state and the in-charge in another. This makes communication even more important. It helps staff feel connected to the team.

## C. Self-review

The reviewer should encourage the preparer to perform a self-review. Reviewer-friendly workpapers dramatically improve audit quality and improve audit efficiency. Reviewer-friendly workpapers improve quality by forcing the staff to understand what they are doing and lowering the chance that something will be missed in confusing documentation. Reviewer-friendly workpapers will result in fewer review notes for staff to clear. The following are suggested questions to ask yourself as a workpaper preparer in order to avoid review notes:

- a. **Clarity** – The more significant and complex the audit area, the harder it is sometimes to make the workflow. Often, a summary memo in the front of complex audit areas can give the reviewer a big-picture perspective and provide a roadmap to the detailed testing.
- b. **Completeness** – The staff accountant should provide an open items list to the reviewer if there are items missing.
- c. **Easy to read and understand** – Most workpapers now are electronic so at least the reviewer doesn't have to deal with handwriting. Spelling and grammar can still be an issue even though spelling and grammar check are embedded in word products. The biggest issue that staff people face is not documenting their thought processes. Spreadsheets should be reviewed for clarity so that the reviewer can see what each number means if it is not evident.
- d. **Organization** – Workpapers should be thoughtfully organized and arranged in an order that facilitates easy review. Keep similar topics together.
- e. **Clarity of expression** – Clean up wordy memorandums, duplicative explanations, useless columns, etc. If it is a client-prepared schedule, team with the client before fieldwork begins to put the documentation in a format that works for both internal management and external audit purposes.
- f. **Ensure cross references are on the workpapers** – This will make the work easier to follow.
- g. **Read the documentation again for “smoking guns”** – Sometimes auditors will write whatever pops into their heads. These red flags cause breaks in linkage as was discussed in an earlier module. The author has seen the following statements while reviewing workpapers:
  - (i) **“Per Jennifer...”** – In this statement, Jennifer was the audit manager. The audit team, no matter how knowledgeable, is not authoritative.
  - (ii) **“Close enough for government work”** – This was on a governmental audit.
  - (iii) **“This looks like it could be trouble”** – The auditor was talking about an increase in the account balance that appeared large while performing preliminary analytical review.
  - (iv) **“I need to follow up on this”** – This was noted in an analytical review. It is a broken link unless it is brought forward to the team meeting for discussion. There are better ways to say that if this is the case.
  - (v) **“The client never does this correctly”** – This is an inappropriate comment. If there are deficiencies, they should be identified as such and discussed with the team to classify as significant deficiencies, material weaknesses or simply deficiencies.

- h. **Take care to document the work performed and not just perform rote signoffs** – It is important to document the steps performed. Checklists make it tempting to just sign off when a step says, “make inquiries.” It may appear to the auditor that this is sufficient, but if the checklist asks for a procedure such as an inquiry, then the auditor should prepare documentation as to who they spoke with and the results.

The following is a self-review checklist that may be used to assist in correcting workpaper deficiencies **prior** to supervisory review:

1. Is it properly titled?
2. Does the heading indicate the balance sheet date?
3. Is it indexed?
4. Did the preparer sign and date?
5. Is the purpose of the workpaper readily apparent or clarified with supplemental narrative?
6. Have all audit program steps that should be included in the workpaper been addressed?
7. Are all numbers linked to a general ledger account number, as appropriate?
8. Is the source of audit evidence clear?
9. Have supporting schedules been considered for completeness (e.g., footed, reconciled to T/B etc.)?
10. Are specific items tested clearly identified, and the method for selection clear?
11. Are the workpapers free of extraneous comments that might lead a reviewer to assume there was risk when there was not?
12. Are all risks brought to the team meeting documentation?
13. Are the risks either dispensed with in the team meeting documentation or carried forward to risk assessment summary?
14. Are inherent risk and control risk separately evaluated for each account balance or class of transaction at the assertion level?
15. Is revenue recognition considered a significant fraud risk (or documented as to why not)?
16. Is management override deemed a significant risk?
17. Are risks appropriately linked to further testing either in a commercial audit program or a program written by the auditor?
18. Is the source of audit evidence clear?
19. Have supporting schedules been considered for completeness (e.g., footed, reconciled to T/B etc.)?
20. Can an experienced reviewer with no prior knowledge of the specific client reperform your work?
21. Are all items selected for testing investigated and concluded on?
22. Is the nature and basis for all significant transactions and events readily apparent or clarified with supplemental narrative?
23. Are key judgments and assumptions made by the client clearly explained and challenged?
24. Are standard tick marks used? Do all tick marks have an explanation?
25. Are there any individually significant or unusual transactions or events that have not been addressed?
26. If appropriate, was there indication of footing?
27. Are numbers cross-referenced to clearly show the flow of information?
28. Are cross-references meaningful for purposes of the workpaper?

29. Have any prior year numbers been agreed to the final audited numbers in the prior year audit file?
30. Are any possible adjusting entries identified, investigated, and disposed of, or accumulated?
31. Have control deficiencies been taken to a central point for evaluation?
32. Does each workpaper, or group of workpapers, stand on its own, and contain all the information necessary to understand it?
  - a. For analytical review procedures, did the auditor identify your expectations of what the balance should be?
  - b. Did the auditor describe how your expectations were developed?
  - c. Did the auditor state how results compared to actual client data?
  - d. Did the auditor address significant differences and state how they were resolved?
33. Are the financial statements reconciled to the underlying accounting records?

#### **D. Timely review of workpapers and discussion with staff**

Timely review of staff workpapers can pay off in a number of different ways:

- a. Issues are identified early and can be addressed.
- b. It takes more time for staff to clear review comments when time has elapsed and they have moved on to other areas or even worse, another engagement.
- c. By reviewing promptly, it allows other reviewers to review on a timelier basis as well.
- d. When notes are cleared, reviewing the result to ensure they were properly cleared is important.

Discussing review notes verbally with staff helps them to understand where they went wrong or failed to document according to professional standards. For the most part, staff people want to do a good job and excel in their roles. However, since auditing is learned mostly on the job, their errors and omissions need to be explained to them so that they can correct them and also importantly, not have them recur.

The workpaper reviewer should be polite when writing review comments. A terse comment that demeans the preparer does not help to educate them and it can dampen their desire to work in the field. Review notes should be clear and direct but never sarcastic, demeaning or overly critical. A new reviewer may want to ask themselves, "How would I feel if someone wrote this review comment for me? Am I being nitpicky or insisting on my personal preferences with this comment?"

If the in-charge just writes the notes and sends the documents back to the staff without discussion, the notes may not be cleared the way they need to be, creating more work for the in-charge and ultimately the staff. The engagement suffers.

Even if workpapers are reviewed electronically from a separate location, it might be a good idea to arrange to discuss the workpapers via telephone or in person in order to provide support to the staff. Staff tend to be sensitive to review comments and a conversation in person will help to reinforce that on-the-job training, including review notes, is all part of learning and advancing in the profession.

**Set a budget and deadlines but be realistic.** It is important to set expectations for performance. Less experienced staff don't always know how long an audit area should take. Budgets, however, should be realistic or staff become discouraged. For example, the staff should not be penalized for engagement management taking a low fee in order to retain a client. In addition, a client's failure to provide the

necessary documentation and support for account balances may not be something a staff person can control. One way to prevent this is to ask the staff to let the in-charge know if they are not getting what they have requested from the client once the staff has exhausted attempts to get it themselves. Ultimately, it is important for the staff to take responsibility for communications to the in-charge as well as the client.

## **E. Test Yourself #5**

Which of the following statements is NOT true about reviewing workpapers?

- A. The reviewer should discuss the how's and why's when auditing an area that is new to staff.
- B. As long as the work is reviewed by report issuance, it really shouldn't make much difference when it is reviewed.
- C. The engagement will be more efficient and effective if the reviewer performs their review on a timely basis.
- D. The reviewer should ensure that their review comments are cleared.

## V. Solutions to exercises

### A. Test yourself #2

Which of the following statements is true about professional standards on accounting and auditing?

- A. **The reviewer should take care when reviewing the auditor's report, engagement letters, representation letters, and other communications, since professional standards may change the language.**
- B. The FASB's standards are not as important to the reviewer as the AICPA's standards.
- C. As long as staff follow the prior year's workpapers, the engagement will pass peer review.
- D. Only auditors of public companies need to worry about these standards.

### B. Test yourself #3

How long after the issuance of the report is the auditor permitted to make administrative changes to the workpapers?

- A. 30 days.
- B. **60 days.**
- C. 90 days.
- D. 120 days.

### C. Test yourself #4

Which of the following is NOT true regarding workpaper review?

- A. The reviewer is responsible for tying account balances back to the general ledger and prior year workpapers and ensuring that the detail tested by the workpaper preparer agrees with the account balance for the current year or is reconciled to it.
- B. The reviewer is responsible for ensuring that there is appropriate linkage from planning workpapers to the risk assessment and from the risk assessment to the substantive testing performed.
- C. **The reviewer is responsible for ensuring that internal controls are always tested.**
- D. The reviewer is responsible for ensuring that the audit programs have been signed off up to their level of responsibility.

### D. Test yourself #5

Which of the following statements is NOT true about reviewing workpapers?

- A. The reviewer should discuss the how's and why's when auditing an area that is new to staff.
- B. **As long as the work is reviewed by report issuance, it really shouldn't make much difference when it is reviewed.**
- C. The engagement will be more efficient and effective if the reviewer performs their review on a timely basis.
- D. The reviewer should ensure that their review comments are cleared.

## **E. Exercise 1 – Presumptively mandatory requirements**

Professional standards require that accounts receivable be confirmed. The audit partner on the engagement knew that in situations involving nursing home patients the chances of confirmations being returned were very low. Therefore, he directed the staff to test subsequent payments instead. The workpaper contained a list of the patients selected for testing along with a record of payments vouched and a summary at the bottom showing the extent of the testing performed and the results. Was this documentation sufficient to meet professional standards?

**The auditor performed the step as requested by the partner and documented the items selected and the amount of subsequent receipts vouched. AU-C §330.31 states that “the auditor should include in the audit documentation the basis for any determination not to use external confirmation procedures for accounts receivable when the account balance is material. This was not included in the workpaper. The auditor should provide the rationale for alternative testing as well as what testing was performed and why it was sufficient.**

## **F. Exercise 2 – Preliminary analytical procedures**

An audit firm is auditing a light manufacturing company. The staff have prepared a workpaper on preliminary analytical procedures. You are in the in-charge workpaper reviewer. What might your comments be on this workpaper? Provide suggestions on how it might be improved.

**The expectation could be improved by more discussion with the client personnel, particularly in operations. That might have led the auditor to anticipate that service revenue would be down and product sales would increase. There is no assessment of the amount of the fluctuation (e.g., 10 percent or \$20,000) that might indicate that there is likely to be less risk. This guides the analysis. The staff person analyzed some things that were large fluctuations but missed others. For example, accounts receivable is up by a considerable amount where revenue is down. This was not identified as a risk. The language is very informal, and the reviewer does not really know what the staff member meant. For example, “margin looks high” or “we better look into this.” The workpaper should summarize the items that the auditor intends to carry forward to the team discussion for further brainstorming and conclusion about whether there are significant risks.**

## Learning Questions

1. Which of the following is NOT a purpose of documentation?
  - A. Assist the engagement team in planning the audit.
  - B. Provide a record of audit evidence to support the auditor's opinion.
  - C. Ensure that the firm passes the peer review with no deficiencies.
  - D. Ensure that auditing standards were followed during the course of the audit.
  
2. Which of the following statements is true about the AICPA's EAQ initiative?
  - A. Its purpose is to ensure that peer reviewers only pass firms that demonstrate superior quality.
  - B. The initiative includes a significant educational component for auditors and peer reviewers.
  - C. It is a rigorous standard-setting process.
  - D. It is only principles and does not consider the impact of technology.
  
3. Which of the following is true about the documentation completion date under AICPA standards?
  - A. It is 90 days after the issuance of the auditor's report.
  - B. It gives time for the auditor to finish performing procedures and make any last-minute changes to the workpapers after the report is issued for 60 days.
  - C. It is the date at which the documentation is complete and the file ready to be locked down.
  - D. It is 14 days after the issuance of the report.
  
4. When would an auditor dual date a report?
  - A. A material subsequent event is identified after the date of the auditor's report but prior to report release.
  - B. A significant event occurs prior to the auditor's report date.
  - C. An event of any significance occurs after issuance of the original audit report.
  - D. Never.
  
5. Which of the following is NOT a focus point for the workpaper reviewer related to internal control?
  - A. The reviewer should be alert for instances where the preparer has not assessed the design of the controls.
  - B. The reviewer should be alert for instances where control weaknesses were identified but there was no assessment of whether the weakness was a deficiency, a significant deficiency, or a material weakness.
  - C. The reviewer should be alert for instances where the preparer failed to test internal controls.
  - D. The reviewer should be alert for instances where the auditor relied on inquiry alone to determine whether relevant controls were implemented.
  
6. Which of the following is NOT a tip for working with staff?
  - A. Provide newer staff with guidance before they start their work so that they understand the "why" and the "how."
  - B. When writing review comments, be direct but polite.
  - C. Advise newer staff to go by the prior year workpapers since things don't change much.
  - D. Properly plan and communicate with staff to minimize coaching/review notes.

## Learning Questions – Answers

1. A is **incorrect**. Assisting the engagement team in planning the audit is one of the secondary purposes of documentation.  
  
B is **incorrect**. One of the primary purposes of documentation is to provide a record of audit evidence to support the auditor's opinion.  
  
C is **correct**. The auditor prepares documentation to support the auditor's opinion, not to please a reviewer.  
  
D is **incorrect**. Documentation supports compliance with auditing standards.
2. A is **incorrect**. The EAQ initiative focuses on improving engagement quality by collecting data, analyzing it, and then creating educational materials and programs. Peer reviewers are not asked only to pass firms with superior quality.  
  
B is **correct**. The AICPA created the EAQ in order to assist auditors in improving audit quality.  
  
C is **incorrect**. The purpose of the initiative is to help firms improve their quality and has nothing to do with standard setting.  
  
D is **incorrect**. The EAQ initiative is updated annually and responds to changes in the profession, including technological changes.
3. A is **incorrect**. It is 60 days after the issuance of the auditor's report.  
  
B is **incorrect**. Auditors are only allowed to make administrative-type changes to the workpapers during the 60 days after the documentation completion date. All procedures should be completed before report issuance.  
  
C is **correct**. AU-C §230 requires that the workpapers be locked down no later than 60 days after the report issuance.  
  
D is **incorrect**. It is 60 days after the issuance of the auditor's report. The 14-day window applies to PCAOB audits.
4. A is **correct**. If the auditor discovers a material subsequent event after the date of the auditor's report but prior to report release, the auditor would dual date for the subsequent event.  
  
B is **incorrect**. Dual dating is appropriate only if a significant event occurs after the original audit report date.  
  
C is **incorrect**. An auditor may dual date a reissued report because of a significant event that occurs after the issuance of the original audit report that comes to the attention of the auditor.  
  
D is **incorrect**. Dual dating is rare but is allowable under the standards. If the auditor discovers a material subsequent event after the date of the auditor's report but prior to report release, the auditor would dual date for the subsequent event.

5. A is **incorrect**. The reviewer should be alert for instances where the preparer has not assessed the design of the controls, as this assessment is required and easily missed.
- B is **incorrect**. The reviewer should be alert for instances where control weaknesses were identified but there was no disposition of them. This is a frequent omission of workpaper preparers.
- C is **correct**. The reviewer does not need to be alert for instances where the preparer failed to test internal controls since testing internal controls is generally not required. If the auditor determines that substantive tests alone will not bring risk down to a low enough level, then they would be required to test internal controls.
- D is **incorrect**. This is a focus point for the workpaper reviewer. Inquiry alone is not sufficient to determine whether controls have been implemented; the auditor generally needs additional procedures, such as observation, inspection, or walkthrough procedures.
6. A is **incorrect**. It is very efficient and effective to provide new staff with guidance before they start an audit area.
- B is **incorrect**. It is very important to be direct but polite when writing review comments. This helps staff to see review comments as a learning tool and not a punitive measure.
- C is **correct**. The auditor in charge would never tell the staff to perform just the work that was performed in the prior year because circumstances and risk change from year to year.
- D is **incorrect**. It is important to plan and supervise staff to minimize coaching notes.



# Evaluating Sufficiency and Appropriateness of Audit Evidence

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# Evaluating Sufficiency and Appropriateness of Audit Evidence

## *Learning objectives*

At the end of this course, you will be able to:

- Describe the characteristics of audit evidence;
- Discuss the sources of evidence;
- Evaluate the sufficiency and appropriateness of evidence obtained from tests of controls; and
- Evaluate the sufficiency and appropriateness of evidence obtained during the audit.

## *I. Introduction*

During a financial statement audit the auditor obtains an understanding of the entity and its environment (including its system of internal control), performs a risk assessment and from that work designs substantive procedures that will be responsive to the level of risk assessed. The auditor evaluates the sufficiency and appropriateness of audit evidence. In doing so, the auditor considers the quantity, relevance, and reliability of audit evidence, including its source, and whether such information corroborates or contradicts assertions in the financial statements. The evaluation of the information to be used as audit evidence should include evaluating whether the information is sufficiently precise and detailed for the auditor's purposes as well as consideration of the accuracy and completeness of the information. The work performed is summarized in the Independent Auditor's Report which is illustrated below.

### **Independent Auditor's Report**

#### **Opinion**

We have audited the financial statements of Perry's Paper Products, which comprise the balance sheets as of December 31, 20X1 and 20X0, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements.

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of Perry's Paper Products as of December 31, 20X1 and 20X0, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

#### **Basis for Opinion**

We conducted our audits in accordance with auditing standards generally accepted in the United States of America (GAAS). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are required to be independent of Perry's Paper Products and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audits. ***We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.***

#### **Responsibilities of Management for the Financial Statements**

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America, and for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is required to evaluate whether there are conditions or events considered in the aggregate that raise substantial doubt about Perry's Paper Products' ability to continue as a going concern for one year.

### **Auditor's Responsibilities for the Audit of the Financial Statements**

Our objectives are to **obtain reasonable assurance** about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. **Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with GAAS will always detect a material misstatement when it exists.** The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements are considered material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements.

**In performing an audit in accordance with GAAS, we:**

- **Exercise professional judgment and maintain professional skepticism throughout the audit.**
- **Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.**
- **Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of Perry's Paper Products' internal control. Accordingly, no such opinion is expressed.**
- **Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.**
- **Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about Perry's Paper Products' ability to continue as a going concern for a reasonable period of time.**

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control-related matters that we identified during the audit.

*Holmes and Tripp  
CPAsCanton, MA  
March 26, 20X1*

The module is designed to provide participants with a framework for evaluating the sufficiency of audit evidence. To do this it is important to understand the important characteristics of audit evidence.

## **A. Audit strategy and audit plan**

The auditor should develop an audit strategy and an audit plan. The audit strategy guides the development of the audit plan. The strategy identifies the scope, timing and direction of the audit and includes identification of:

- a. Identification of the characteristics of the engagement that define its scope.
- b. Reporting objectives of the engagement.
- c. The factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts.

- d. The results of preliminary engagement activities and, when applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant.
- e. The nature, timing, and extent of resources necessary to perform the engagement.

**Example:** An audit team was beginning the planning process. The manager and audit senior discussed the elements that were most important to the audit strategy. The client was a new client in the financial services industry. Therefore, team members with knowledge and experience in that area would be selected for the engagement. The client used several service providers so obtaining SOC reports would be a priority early on in case the client did not ask for and maintain them as part of its internal control. There were different additional reports that would be important in the engagement. Many of the documents that the audit team would need were only in electronic form so the team would test internal controls. The partner already had informed the manager that the two of them would be reviewing all significant audit areas due to the risk with a new client in a heavily regulated industry. For many of the firm's engagements the team documented the audit strategy in the audit checklist. However, due to the nature of this engagement, the partner asked for a separate strategy memo.

In addition to the audit strategy the audit team develops an audit plan that includes:

- a. The nature and extent of planned risk assessment procedures.
- b. The nature, timing, and extent of planned further audit procedures at the relevant assertion level that are responsive to the risk assessment.
- c. Other planned audit procedures that are necessary so that the engagement complies with generally accepted auditing standards.

An audit is iterative. Therefore, it is important to update and change the overall audit strategy and audit plan, as necessary, during the course of the audit.

## ***II. Characteristics of audit evidence***

### **A. SAS 142, Audit Evidence**

AU-C 500, *Audit Evidence*, had not been significantly revised since 2005. Much has changed since that time as the size and complexity of audited entities have increased, and technology and its use by auditees and auditors have progressed. In 2017 the AICPA launched a project to assess whether it was time to revise the standard considering these issues. In addition, the AICPA's audit quality initiative identified issues related to lack of professional skepticism. In a separate project the IAASB was also seeing these issues.

The standard not only addresses emerging technologies but also discusses professional skepticism, management specialists, and audit documentation. Its primary focus is to assist the auditor in assessing whether **sufficient and appropriate audit evidence**. In the standard the Auditing Standards Board (ASB) presents attributes and factors for auditors to use in evaluating audit evidence no matter the source or the way the auditor obtained the information (including the use of automated tools and techniques). These attributes and factors will be discussed throughout the module. Although the standard discusses and provides examples of newer technologies and methods, they are not described in detail. SAS 142 is effective now.

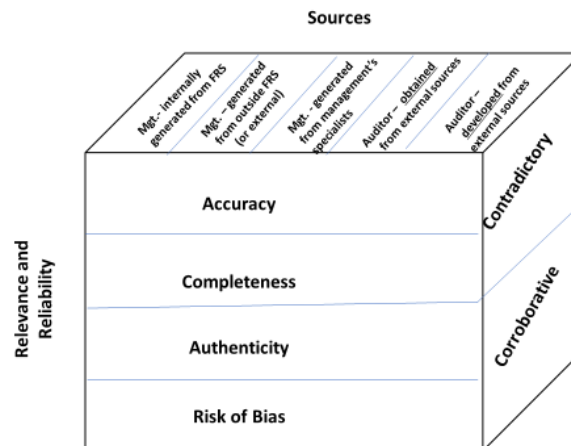
## B. Definitions

SAS 142 contains four definitions that set the foundation for this standard:

- a. **Appropriateness (of audit evidence)** – The measure of the relevance and reliability of audit evidence. Appropriateness relates to the quality of the audit evidence.
- b. **Sufficiency (of audit evidence)** – The measure of the persuasiveness of audit evidence. The persuasiveness of audit evidence necessary is affected by the auditor's assessment of the risks of material misstatement. Sufficiency relates to quantity.
- c. **Audit evidence** – Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based.
- d. **External information source** – An individual or organization external to the entity that develops information used by the entity in preparing the financial statements or used by the auditor as audit evidence, when the information is available for use by a broad range of users.

When information has been provided by an individual or organization acting in the capacity of management's specialist, service organization, or auditor's specialist, the individual or organization is **not** considered an external information source with respect to that particular information.

The standard includes a graphic that summarizes the characteristics of audit evidence, sources of audit evidence and important considerations for auditors to apply as noted below.



### 1. Test Yourself questions 1 and 2 – True or false

1. The sufficiency of audit evidence is measured by its persuasiveness.
2. Work provided by management's specialist is considered external information.

## C. Attributes and factors – Relevance and reliability

During the financial statement audit the auditor accumulates audit evidence to support their opinion on the financial statements. The term *sufficient appropriate audit evidence* is not new. The SAS explains that the attributes and factors in the cube above should be evaluated to determine if sufficient appropriate evidence has been obtained. The auditor should evaluate the information to be used as audit evidence for relevance and reliability. This includes the source and whether it corroborates or contradicts assertions in the financial statements.

The front of the evidence cube discusses the important factors of **relevance and reliability**. The auditor considers the attributes: accuracy, completeness, authenticity, and bias.

### 1. Relevance

Relevance refers to the logical connection with an assertion under consideration. The factors that affect the relevance of information are:

- a. The objective of the procedures to be performed as well as the assertions;
- b. The account balances, classes of transactions or disclosures to which the information relates; and
- c. Period of time to which the information relates.

If the auditor performs an audit procedure that is not responsive to the assertion that the auditor is testing then the evidence is not relevant as described in the example below.

**Example:** An auditor was testing accounts payable. She considered the following:  
a. **Objective of procedures and account balance** – To test the existence or valuation of accounts payable.

When testing existence, the auditor would test the recorded amount of accounts payable. The auditor could confirm accounts payable and reconcile the confirmations to the recorded balance and vendor statements. This would be relevant audit evidence.

- b. **Objective of procedures and account balance** – To test the completeness of accounts payable the information discussed related to the recorded balance would not be relevant. However, information coming from subsequent disbursements, unpaid invoices, unmatched receiving reports, or supplier's statements would be.

When looking at an account balance the auditor has to pay careful attention to the assertions. For example, in evaluating marketable securities, a document (electronic or paper) may provide good evidence for the existence assertion. An external party is confirming that the asset exists and is owned by the entity, like a financial institution. However, that confirmation does not support the valuation assertion. The auditor also needs to consider valuation through other tests.

External confirmations can be very useful for more than account balances. The auditor might request confirmation of terms and conditions or even the absence of other accounts. For example, a bank confirmation will provide a balance (existence) but can also provide evidence of additional accounts that might be open or liabilities that the entity may or may not have disclosed.

**Example:** An audit senior was testing revenue and accounts receivable. She sent out confirmations to the largest accounts to determine whether the balances existed. She also evaluated subsequent receipts to evidence the amount being paid and that it existed at the balance sheet date. Confirmations and subsequent receipts are also supportive evidence for rights and obligations. The audit manager asked her to go back and perform a test of valuation by looking at the aging report and evaluating how many of those balances were paid. She also asked her to look in hindsight to determine if the allowance for bad debts was adequate in the prior year. Finally, she asked her to consider the aging of the receivables given the historical knowledge of the client's ability to estimate as well as any current conditions identified during the risk assessment process. These procedures, however, did not test completeness of revenue and receivables. The auditor generally tests debit balances (receivable) for overstatement and credit balances (revenue) for understatement.

Analytical procedures are very helpful in this regard. The manager helped the senior auditor to develop an appropriate analytical procedure.

## **2. Reliability**

The reliability of information is affected by accuracy, completeness, authenticity, and the risk of bias. This will vary depending on whether the information is obtained from internal or external sources. Generally, information from external sources tends to be more reliable as long as it is relevant and comes from a reputable unbiased source. The auditor's judgment and professional skepticism play a significant role in their consideration of reliability.

- Example:** An audit senior wanted to perform substantive analytical procedures for a home health company. She knew that industry statistics were easy to obtain and was aware of a reputable company that provided those statistics. She wanted to predict the balance of several operating expenses as a percentage of revenue. Although the source was external, and she deemed the data reliable she also wanted to be sure that the statistics were relevant for her client. To do this she needed to evaluate how much like the average, as reported by the data source, was her client. She considered:
- a. Did her client tend to be more or less efficient than the industry average?
  - b. Was it larger, smaller or approximately the same size? Economies of scale may play a role in the level of expenses.
  - c. Does the client operate in an area of the country that is significantly more or less expensive than the industry average? If prices tend to be relatively fixed, as they are when government payors are involved, then this may be a very important consideration.

### **Internal controls**

When data is internal to the entity a good way to evaluate reliability is to evaluate the organization's system of internal controls. Information is more reliable when controls over its accumulation, preparation and maintenance have been tested. Note that this information could be tested by the external auditor or if the information is accumulated, prepared and maintained at a service organization, then a combination of the service organization's auditor and the user auditor (complementary user controls).

Evidence accumulated in testing controls could be derived from written records such as board of director meeting minutes, observation by the auditor, evidence in documentary form such as an approval of an invoice, or orally. It is always important to obtain oral explanations for how a control is performed. One way to do this is through corroboration of an assertion by an employee by an internal or external third party. However, oral evidence alone is not as persuasive as review of documents or observation.

### **Outsourced processes**

According to IBIS World, a research company, there are 262,467 Business Process Outsourcing (BPO) Service businesses in the U.S. as of 2023, an increase of 3.4 percent from 2022. It is important to remember that when information from outsourced process is included in the general ledger, as it most often is, management is still responsible for the internal controls even though the processing is performed by a reputable company. This means that management needs to obtain information about the reliability of controls from the service organization. This is frequently done by obtaining a Service Organization Control (SOC) report. Unless the services performed are not significant to the financial statements the auditor will need to obtain an understanding of the internal controls over that process.

In some cases, where there is significant interaction between the entity and the service organization (SO), which may be the case in the payroll application, then a SOC report will not be necessary. The auditor will obtain an understanding of the internal controls at the entity. But where there is less interaction between management and the service organization or information is only available in electronic form then the auditor will need to obtain the understanding of processing controls by obtaining a SOC report. Along with that, the auditor will need to understand (or test if control reliance is needed) the complementary user controls that are identified in the SOC report.

Other evidence provided by an SOC report should be documented as well.

- a. **Understand the nature of the Service Auditor** –The user auditor may or may not be familiar with the Service Auditor. Not all Service Auditors are public accounting firms that are known to have deep experience in this type of work. Service Auditors may be smaller public accounting firms or firms not in public accounting at all. This does not make them inadequate. However, the user auditor may want to make inquiries to be sure that they are subject to regulatory oversight. The Service Auditor may be practicing in a jurisdiction with different standards than those set forth in AT-C 320. Unless evidence to the contrary comes to the attention of the user auditor, they should assume that the Service Auditor is independent.
- b. **Identify important information in the SOC report document** – The user auditor will want to look at the layout of the SOC report document to determine the document contains the elements necessary for a type 1 report on the suitability of the controls or a type 2 report on the suitability and the effectiveness of controls. The table of contents is an easy way to spot the differences along with whether there are subservicing arrangements. The user auditor will want to obtain this information early in the audit in case they find it necessary to request additional information.
- c. **Coverage dates relative to a Type 2 report** – The auditor will look at the dates covered by the report to determine the periods covered by the tests performed by the service auditor. The period covered by the SOC report should be a substantial amount of the period represented by the financial statement audit. The user auditor needs to consider the period covered by the SOC report and the period elapsed since the end of the period covered by the SOC report.

Professional literature does not prescribe a specific level of coverage. The AICPA has unofficially said that where the period of overlap is less than 9 months the auditor should consider further procedures. If there is no overlap, the period is too short or too much time has elapsed between the end of the period covered by the report, the external auditor will need to determine if they need more evidence. One popular way to document any changes at the SO is to obtain a bridge letter. A bridge letter is a letter that bridges the “gap” between the SO’s report date and the user organization’s year-end. It is a tool used by SOs so that the user entities do not need to wait for the next report. It is on the SO’s letterhead and typically signed by the SO. User auditors need to be aware that the service auditor does not opine on it, so it does not have the weight of a service auditor’s report.

- d. **Understand the systems covered by the report** – A SO will frequently provide several services to clients that span several different systems. A particular SOC report may only cover one or two of them.

- e. **Look for the existence of subservicers** – A user entity might contract with a SO that outsources some of the services in the agreement to a subservice organization. These may be relevant to those user entities' internal control over financial reporting. The subservice organization may be a separate entity from the service organization, an affiliated company or other related party. Either way, this could cause the user auditor to need to consider the controls at the subservice organization.

Where there is one or more subservice organizations involved, the interaction between the activities of the user entity and those of the service organization is expanded to include the interaction between the user entity, the service organization, and the subservice organizations. The degree of this interaction as well as the nature and materiality of the transactions processed by the service organization and the subservice organizations are significant interest to the user auditor when considering the significance of the service organization's and subservice organization's controls to the user entity's controls.

In cases where there is a subservice organization the SO may or may not take responsibility for their controls and include the description, objectives, and controls in the scope of the service auditor's engagement. If the subservice organization is included in the scope this is considered the inclusive method. If not included in the scope, it would be considered the carve-out method.

If the services of the subservicer are carved out then the user auditor will have to evaluate the effect on the controls over that system as a whole and determine whether internal control deficiencies in the portion(s) carved out could cause a material misstatement. The existence of subservicers will be noted in the auditor's report as well as in management's assertion.

- f. **Obtain an understanding of complementary user controls** – The SOC report will discuss the need for the entity to establish complementary user controls. These are the controls over the input and output from the SO (reports) that are at the entity. The SO is only responsible for the processing at its entity. The complementary user controls complete the controls from cradle to grave.
- g. **Evaluate deficiencies noted in the report** – The auditor will first note whether the opinion on the SO's controls is modified. This indicates serious deficiencies. More often there are deficiencies noted that were not serious enough to modify the Service Auditor's report. In a type 2 report the auditor's testing and results may identify one or more instances of noncompliance with a control. The auditor will evaluate the impact on the system of internal control. In an SOC 1 report there could be deficiencies of the design or implementation of the control. The auditor will evaluate the impact of these deficiencies on their understanding of the system.

If a SOC report is not available or the SOC report has too many deficiencies to yield an adequate understanding of internal controls, the auditor will need to identify other methods of gaining the evidence they need to support an understanding or testing of internal controls. If the auditor is unable to obtain the evidence this will affect their opinion on the financial statements. The auditor may need to consider a report qualification or a scope limitation.

### 3. Test Yourself question 3 – True or false

3. The auditor will always need to obtain an SOC report when a portion of the financial reporting system is outsourced.

#### Testing evidence for accuracy and completeness

Evidence should be tested for completeness and accuracy. Before choosing a sample, the auditor should reconcile the population from which the sample is chosen to the general ledger to ensure completeness. Tests of controls also provide evidence about completeness.

An auditor may also use information developed outside of the financial reporting system as audit evidence. The auditor could use the entity's performance measures for substantive analytical procedures (SAP). To ensure that the report with the performance measures is accurate and therefore precise enough to use in an SAP, tests of controls or tests of accumulation of information could be needed.

**Example:** An auditor wanted to perform an analysis on cost of sales. He knew that the operations director was vigilant in measuring this profit margin by product line each month. He obtained the reports and calculations used by the operations director and tested them to ensure that the data was complete and that it tied to the general ledger. He then performed some tests of recalculation.

#### Testing evidence for authenticity

Auditors are required to consider the possibility of fraud in a financial statement audit. Professional literature makes it clear that auditors are not authentication experts but should always maintain professional skepticism. This is highlighted in this and several of the other new audit standards. If there is suspicion that a document may be fraudulent the auditor will address this by corroborating the evidence by other means.

**Example 1:** The sales department at a client provided an auditor with a scanned version of an executed sales contract. Since the contract was not an original the auditor considered whether it would be more effective and efficient to confirm key terms with the third party or test the operating effectiveness of internal controls around the operating effectiveness of the execution of the original contract and maintenance of the scanned version.

**Example 2:** An auditor was aware that the client scanned or obtained many source documents electronically in order to save storage space and reduce the entity's footprint. During the audit of investments, she noted that the investment statement looked as if it could be altered. Since investments were not material to the balance sheet and were deemed to be of less risk since they were all publicly traded, the auditor generally obtained the end of the year statement and used it for testing rather than confirming the balance. The auditor asked the controller to sit with her and she went to the client's portal to obtain the source document herself. She downloaded the document and compared it to the client's copy. She discovered that one of the balances at the bottom of one page was altered so that the balance of investments was lower by \$10,000. This caused her to perform further procedures.

#### Testing evidence for the risk of bias

The risk of bias is present in all audits, particularly as it relates to estimates. There are two forms of bias, management bias and auditor bias.

**Management bias** – An auditor performs either new client acceptance or client continuance procedures each year. A major consideration in this evaluation is the ethical values of the higher-level client personnel. It is still important to exercise professional skepticism and remember that management bias may not be intentional.

There is a higher risk of management bias when information comes from internal sources. There are several considerations here:

- a. The ability of the entity to influence the external information source;
- b. Management's selection of information so that it "proves" management's assertions; and
- c. Management's unknowing use of information from an external source that is biased.

**Example:** An auditor was considering an estimate for the valuation of accounts receivable. There were several balances due that were greater than 120 days old. The auditor noted that the amount allowed for credit losses on these balances was low. The accounting manager was adamant that the balances were fully collectible and no allowance was needed. In addition, the accounting manager used a reserve methodology where the industry average of 5% of revenue was used as an overall reserve. The auditor was concerned that the 5% was too low, particularly in light of the amount of greater than 120-day balances. The auditor wondered if the accounting manager was under pressure to show results and was therefore reluctant to propose an adequate reserve or write off old balances. It appeared that the risk of management bias was high.

**Auditor bias** – Auditor's bias may actually be more challenging to address. The auditor's judgment may be hampered by:

- a. **Availability bias** – The auditor chooses information that is easily retrievable as being more likely, more relevant, and more important for a judgment.
- b. **Confirmation bias** – The auditor looks for information that is consistent with initial beliefs or preferences.
- c. **Overconfidence bias** – The auditor overestimates their ability to make accurate assessments. For example, in the case of complex financial instruments the auditor does not seek outside assistance to assist in evaluating an assertion.
- d. **Anchoring bias** – The auditor assesses an account balance by starting with a number and not adjusting far enough away from the initial value.

**Example:** An auditor was performing an analytical procedure on payroll during an audit. He began with the prior year balance of payroll expense, divided it by the prior year number of employees and multiplying it by the current year number of employees. He also adjusted the resulting balance for the average raise received by the employees. He concluded on the workpaper that the amount of the client's payroll balance was "reasonable" since the amount of deviation from actual was off less than tolerable misstatement.

Toward the end of the audit the payroll supervisor went on medical leave. The accounting manager took on his duties. She was reviewing the bi-weekly payroll and noted that there was an employee she knew had been terminated during the year. She reported it to the CFO. The payroll supervisor made changes in the system so that the terminated employee's pay was deposited into his bank account. He also altered the payroll records so that the amounts of pay were not reported to the IRS, so no withholdings were taken. The supervisor prepared the 941s and reconciled them to the general ledger. He altered the reconciliations. The auditor's expectation was off by the amount of that employee's pay for the majority of the year which was material. This is an example of anchoring bias and confirmation bias.

## D. Sources of evidence

The top of the evidence cube identifies these five sources of evidence:

- a. From management – Generated internally from the financial reporting system;
- b. From management – Generated outside the financial reporting system, including from sources external to the entity;
- c. From management – Obtained from management’s specialists;
- d. Auditor – Obtained from sources external to the entity; and
- e. Auditor – Developed from sources internal or external to the entity.

The auditor may use one or more of the sources identified above.

**Example:** An auditor of an entity with a defined benefit pension plan was evaluating audit evidence used by management in their estimate of the accumulated benefit obligation. Some of the information involved in the calculation was generated internally from the financial reporting system. Other information was provided by an actuary, who was considered one of management’s specialists. The auditor tested that information by obtaining, understanding, and testing the accumulation of data provided to the actuary by management. Then the auditor tested the information provided by the actuary using the audit guidance in AU-C 620, *Use of an Auditor’s Specialist*, that is relevant when management uses a specialist.

### 1. Internal information – Data analytics and methodologies used in auditing

In the past much of the internal information requested by an auditor consisted of source documents such as checks, invoices, contracts, ledgers, journal entries, spreadsheets, cost allocations, computation, reconciliations, and disclosures. And most of it was in paper form. With the many advances over the years in information technology, a significant amount of evidence is now in electronic form either having been transmitted to or from the client electronically or scanned in when received. Other internal forms of data might come from outside accounting in the form of sales, marketing, or other system generated reports.

Auditors traditionally performed manual testing of internal controls and substantive testing along with straightforward analytical procedures using computer aided audit techniques. However, as companies and their systems and processes have become more complex and clients embrace newer technologies, auditors are, in many cases, expected to do the same.

Audit data analytics is described as a technique that analyzes patterns, identifies anomalies, or extracts information from data through analysis, modeling, or visualization. Some of the data used in these tests is financial and some is operational. Regression analysis is an analytic technique that, if properly performed, can identify anomalies in data that have a likelihood of indicating risks of material misstatement. Model the relationship between a dependent and independent variable. It can be used to predict account balances by identifying anomalies in a data set. The key here is to have the appropriate level of knowledge of the entity’s business drivers because without that the procedure will yield inaccurate results.

**Example:** An auditor wanted to test retail sales by regression analysis. The auditor obtained information about square feet in the retail store, data on sales levels for five years from management (internal) and changes in the consumer price index (external). If these are the appropriate drivers of sales, then the procedure should yield appropriate results. However, if there was a change in the product mix so that the store was no longer selling as many higher value products, the results may not provide appropriate evidence.

Auditors may want or even need to be able to perform more sophisticated data queries and then portray the data visually so that patterns can be seen more easily. Data analytics can be used effectively for those purposes. This adds value to the auditor's work and also adds value to the client. These more sophisticated analytics are not without risk. If the data is not relevant and reliable the test will not provide appropriate evidence. Auditors need to consider the need for tests of controls or tests of accumulation of information to provide evidence of reliability of the data used. They also need to be skilled in understanding the client's business to ensure that the right data is used. They also need to be skilled in the application used to perform the test.

## **2. Newer uses of technology that impact an audit**

Audit data analytics is by far the most widely accepted of the newer audit methodologies. SAS 142 mentions other techniques that can be used by auditors but does not go into detail describing them.

These are briefly described here:

- a. **Artificial Intelligence (AI)** is a set of algorithms that perform work that traditionally requires human intelligence. The algorithms are created to classify, analyze, and draw predictions from data. There are a number of different AI applications that involve acting on data, learning from new data, and improving predictability over time. AI can be simple or very complex. Some of the simpler examples are Google Search, Alexa, Siri and other personal assistants, ChatGPT, and image recognition software.
- b. **Machine learning** is a type of AI. Machine learning feeds a computer with data and uses statistical techniques to help it "learn" how to get progressively better at a task. For example, if a user feeds a computer with large amounts of data on sales and advertising dollars spent, machine learning is used to see the patterns in data and make predictions of future sales based on dollars spent. Another useful application is the use of computer vision to read and analyze complex contracts.
- c. **Robotic process automation** is a technology application that automates routine business. An entity can use this tool to capture and interpret applications for processing transactions, manipulating data, triggering responses, and communicating with other digital systems. Applications of RPA can be very simple. For example, a robot can be created that generates an automatic response to an email. Some applications take routine business processes and automate them. For example, RPA can be constructed to take an electronic invoice, match it to a purchase order and receiving documents and either approve or reject it until discrepancies can be resolved. Auditors can use RPA to streamline repeatable processes as well.
- d. **Remote observation tools** such as drones can be used for many applications such as to count inventory in difficult to reach places.

Automated techniques may also be used both as risk assessment procedures and as substantive procedures concurrently if the objectives of both types of procedures are achieved. The auditor needs to understand these techniques, if used by the client, to ensure that any evidence obtained is appropriate.

## **3. Test Yourself question 4 – True or false**

4. When the auditor uses data from the entity to perform substantive analytical procedures, an important step will be to understand the completeness and accuracy of the data.

#### 4. External information

External information can be more challenging to test since the auditor may have less access to determine reliability and may be biased to believe that since the information is external to the client it is automatically reliable.

As defined earlier in this chapter, external information sources develop information that is available for use by a broad range of users. An external source is **not** a management's specialist, a service organization, or an auditor's specialist. External sources could be pricing services, governments, central banks, stock exchanges, media, or academic journal.

The auditor may consult these sources to obtain:

- a. Prices and pricing-related data;
- b. Macroeconomic data, such as historical and forecast unemployment rates and economic growth rates, or census data;
- c. Credit history data;
- d. Industry-specific data, such as an index of reclamation costs for certain extractive industries or viewership information or ratings used to determine advertising revenue in the entertainment industry;
- e. Mortality tables used to determine liabilities in the life insurance and pension sectors; and
- f. Documents or records on websites or in databases or distributed ledgers.

An entity or individual acting as a specialist or service organization may fill more than one role and professional judgment may be necessary to determine the capacity in which the person or organization is acting at a particular time.

**Example 1:** Actuaries are frequently involved in valuations, for example pension liabilities or claims payable. Acting in this capacity the actuary is not an external source. But when actuarial firms publish data on mortality or other such information they are functioning as external sources.

**Example 2:** Certain valuation specialists use models such as Black Scholes to estimate the valuation of derivative instruments since there is no observable market. If that entity is engaged to provide specific valuations and gives information to management for use in the entity's financial statements, then that entity is functioning as management's specialists. However, if the valuation company prepares information and provides it to the public and the entity takes and uses that information in its own estimation methods then the company would be considered an external source.

The auditor will need to consider the relevance and reliability of the information no matter whether it was obtained by management or the auditor. With external information the auditor considers:

- a. Information about the external information source or the preparation of the information by the external information source;
- b. Audit evidence obtained through designing and performing further audit procedures;
- c. Why management or, their specialist uses an external information source, and how the relevance and reliability of the information was considered so that the auditor can consider those attributes or variables;
- d. The nature and authority of the external information source;
- e. The ability of management to influence the information obtained, through relationships between the entity and the external information source;

- f. The competence and reputation of the external information source with respect to the information;
- g. Past experience of the auditor with the reliability of the information provided by the external information source;
- h. Evidence of general market acceptance by users of the relevance or reliability of information from an external information source for a similar purpose to that for which the information has been used by management or the auditor;
- i. Whether the entity has in place controls to address the relevance and reliability of the information obtained and used;
- j. Whether the information is suitable for use in the manner in which it is being used;
- k. Alternative information that may contradict the information used;
- l. Nature and extent of disclaimers or other restrictive language relating to the information;
- m. Information about the methods used in preparing the information and how the methods are being applied including, where applicable, how models have been used in such application, and the controls over the methods: and
- n. Information relevant to considering the appropriateness of assumptions and other data applied by the external information sources in developing the information obtained.

Should the auditor have doubts about the reliability of the information they may decide to perform a comparison of the information obtained from the external source with information obtained from another independent information source. The auditor could also consider obtaining an understanding of management's controls over the reliability of external information and perhaps even test them.

If the auditor does not have a sufficient basis to consider the relevance and reliability of information from an external information source, it could mean that there is a scope limitation. If alternate evidence cannot be found, then the opinion may have to be modified.

### **5. Evaluating information used as audit evidence**

Audit evidence can take many different forms depending on how it is accumulated. Different forms of evidence include:

- a. **Oral evidence** – Oral inquiries are made during the audit to internal sources such as management or to external sources such as attorneys. Inquiries are often the place the auditor starts in developing their understanding of the entity and its environment including internal control. **Oral inquiries should be backed up with other forms of evidence.**
- b. **Visual information** – Auditors use observation in risk assessment procedures such as understanding an entity's internal control. Observation is also used in connection with physical inventories. For example, an auditor could observe a message that appears on client personnel's computer screen evidencing restricted access to an IT application. Drones or video technology could be used as remote observation tools to facilitate inventory observations.
- c. **Paper documents** – Auditors will probably continue to see paper documents as forms of evidence for the foreseeable future until such time as entities embrace electronic forms of transmission. For example, executed contracts, leases, loans, and written confirmations are often presented to the auditor as paper documents.

- d. **Electronic information** – Many documents that at one time were presented to the auditor in paper form are now electronic and this trend will continue. Paper documents such as a paper contract can be scanned. Alternatively, some documents are executed electronically using DocuSign or a similar application.
- e. **Data** – Data that is stored in the entity's IT system or obtained from an external source may be either manually input into the system or electronically generated. For example, there is often an electronic interface between an entity and a service organization which is used to transmit data.
- f. **Client records** – The auditor also inspects records that may be in paper form such as accounting entries, checks, electronic fund transfer confirmations, invoices, contracts, ledgers, journal entries, spreadsheets, cost allocations, reconciliations, and disclosures.
- g. **Information from published sources** – In performing procedures like regression analysis the auditor may use information from trade groups or government agencies often in combination with information from management.

**Example:** An auditor wanted to perform a predictive substantive analytical procedure on cost of sales of certain products. She obtained an index of product cost increases from a trade group and used that along with information provided by management on square footage of retail space and historical margin information to predict cost of sales by regression analysis.

## E. Corroborative or contradictory information

The other side of the evidence cube illustrates the effect of corroborative and contradictory information. AU-C 330 states that when the auditor forms a conclusion about whether sufficient evidence has been obtained, they should consider **all** the evidence no matter if it corroborates or contradicts the assertions. Contradictory and corroborative information is considered together not in isolation. Sometimes the absence of information is used by the auditor and constitutes evidence.

**Example 1:** An auditor was auditing a financial institution with an extensive portfolio of loans secured by real estate in one geographic area. The auditor obtained industry information about the market where the real estate was located that contradicted the appraisals management gave the auditor to support the value of the collateral. The auditor had to perform additional procedures to reconcile the difference.

**Example 2:** An auditor was evaluating information related to management's assertions about the recorded balance of the entity's provision for warranties for a certain product. She inquired of the people handling returns of product and asked to see reports to determine the amount of sales returns during the period. She noted an absence of sales returns of the product in question which supported management's assertion about the completeness of the provision for warranties.

## F. Audit procedures

The auditor obtains audit evidence by performing risk assessment procedures, tests of controls (when required or when the auditor chooses to perform them) and substantive procedures which take the form of tests of details and SAPs. Other audit procedures include sending attorney confirmations, obtaining a representation letter, updating for subsequent events, evaluation of the financial statements for presentation and disclosure and final analytical review.

An auditor may use manual techniques or automated techniques such as audit data analytics to process, organize, structure, or present data in a specific context in order to generate useful information that can be used as audit evidence.

These days some information may be available only in electronic form or available only at certain points or periods in time. This can impact the auditor's testing strategy. If the entity's data retention policies are not long enough the auditor may need to ask the client to retain certain information during the year so that it can be used during fieldwork. The auditor may also choose to perform procedures when the data is available. Other electronic information such as records maintained on a blockchain is more likely to be available on a continuous basis during the audit making it easier for auditors to use audit data analytics or artificial intelligence to obtain information about transactions on a real-time basis.

Other audit procedures performed may include inspection, observation, confirmation, recalculation, reperformance, analytical procedures, and inquiry. Auditors use the procedures they believe will be most effective and efficient. Some of these procedures may lend themselves using automated tools. Inquiry is a very important part of auditing and can lead to further testing in some areas, but auditors should be aware that inquiry alone does not provide sufficient appropriate audit evidence.

### **1. Controls over information to be used as audit evidence**

When information is transformed from its original state, whether its scanned, filmed, digitized or transformed by other means, the data may lose its reliability. Accordingly, the auditor may need to perform additional audit procedures to address the reliability of the data such as inspection of the original documents or tests of internal controls over the transformation and maintenance of the information.

Testing controls becomes even more important when the information is electronically initiated, recorded, processed, or reported and is only available in electronic form. Here the sufficiency and appropriateness of the evidence usually depends on the effectiveness of controls related to data accuracy and completeness. When the source documents are electronic there is more risk that the documents could be inappropriately initiated or altered, and the fraudulent activity remain undetected.

As previously discussed, it is important to test information for completeness and accuracy when using it in a substantive analytical procedure.

### **2. Inspection**

Auditors have always performed physical inspection of assets and documents. Over the years, things have evolved so that the documents are now, in large part, in electronic form. An automated technique that is being used currently is artificial intelligence programs that use text recognition programs to examine documents. These programs identify items for further audit consideration. Based on the risk involved it may be important to perform site visits to physically inspect the existence and condition of significant assets.

### **3. Observation**

Observation consists of looking at a process or procedure being performed by employees. One example is the observation of inventory. Where this can be a manual process, automated tools, and techniques such as use of drones not only assist but can add accuracy to a process.

**Example:** An audit firm had a client with a significant amount of inventory in several warehouses. Management began using the drones to try to solve the continued differences between the perpetual inventory and the general ledger. They used drone technology to do cycle counts every month. The drones scanned the bar codes and took video which enabled management to understand where bar codes were damaged and needed to be replaced, identified issues earlier so they could be corrected, and cut down on manual errors made when humans performed the counts. In addition, it provided better coverage since the drones could do accurate counts in difficult to reach places. The client permitted the auditors to observe the use of the technology for counts during the year and also permitted them to use the technology to take test counts themselves.

#### **4. External confirmation**

An external confirmation is a direct response knowingly provided to the auditor by a third party (the confirming party).

#### **5. Recalculation**

Recalculation consists of testing the mathematical accuracy of information. Recalculation may be performed manually or using automated tools and techniques. Auditors have been using technology to recalculate reports as well as foot the general ledger.

**Example:** An auditor wanted to recalculate gross margin for each product sold to use in an analytical procedure. He was able to use automated tools to make those calculations. The process saves time and improves accuracy.

#### **6. Reperformance**

Reperformance involves the independent execution of procedures or controls that were originally performed as part of the entity's internal control.

#### **7. Analytical procedures and use of audit data analytics**

Auditors frequently use analytical procedures to test revenue and expense accounts as well as some balance sheet accounts. They are also used in risk assessment to identify anomalies in data that may point to a significant risk. When used as a risk assessment procedure a visual of transactional detail can provide auditors with an illustration of the volume and dollar value of a population. If the analytic can provide sufficient precision, the same analytic could be used for both risk assessment and substantive testing. The auditor may also use audit data analytics to obtain evidence about the effectiveness of the entity's internal control.

**Example 1:** An auditor wanted to test automated controls over sales invoices. The system was supposed to identify errors when the invoices were out of sequence or when duplicates existed. Data analytics were used to look for these issues. Not only did this procedure test an automated control, but it also provided information about the completeness of invoices issued during the period.

**Example 2:** An auditor was testing entity level internal controls and obtained information from the internal audit department to support the entity's monitoring activities. He decided that the information would be good to use in a substantive analytical procedure. Before using it, the auditor evaluated the information to ensure that it was sufficiently detailed and precise to use for the secondary purpose.

**Example 3:** An auditor wanted to use audit data analytics as a risk assessment procedure to look for unusual transactions or events and amounts, ratios, and trends that might indicate an area of higher risk. She found it easier to spot issues by looking at visualizations of transactional detail. She prepared an analytic of sales data displayed as a visual highlighting per unit values and number of items in a population. Although the procedure was primarily performed as a risk assessment procedure, the auditor determined that it yielded sufficiently precise information and the output could be used in a substantive analytical procedure as well.

Auditors scan the general ledger to look for significant or unusual items to test. They can use programs to perform data analytics that will help them extract data that meet certain parameters. For example, a query could be made for transactions ending in round numbers or transactions that are right above a dollar value required for additional approval. The auditor can use automated tools to run Benford's law, an algorithm that predicts anomalies in a population based on the expected frequency and placement of numbers in a monetary transaction.

### **8. Inquiry**

Inquiry consists of seeking information, both financial and nonfinancial, from knowledgeable persons within the entity or outside the entity. Auditors use inquiry throughout the audit, coupled with other audit procedures. Evaluating responses to inquiries is an integral part of the inquiry process. Corroboration helps to confirm what one person has told the auditor. Often this is used in an understanding of internal control.

## **III. Evaluating the operating effectiveness of controls**

The auditor is not required to test internal controls unless information is only in electronic form or is of a nature that substantive tests alone will not provide sufficient audit evidence. The auditor may always elect to test internal controls.

### **A. Control reliance**

The auditor will need to determine how much reliance they need to place on a control. This will drive the design and performance of the tests. More persuasive audit evidence is needed when control risk needs to be reduced to lower level. For example, a higher level of assurance will need to be obtained about the operating effectiveness of controls when it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures. As noted earlier, as accounting systems become more automated this situation will become more prevalent.

When designing and performing tests of controls, the auditor should perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls. These may include:

- a. Making observations on how the controls were applied at relevant times during the period under audit.
- b. Evaluating the consistency with which the controls were applied.
- c. Understanding how the controls were applied, including whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

- d. Determining whether the controls to be tested depend upon other controls (indirect controls) and, if so, whether it is necessary to obtain audit evidence supporting the operating effectiveness of those indirect controls.

Controls should be tested throughout the period for which the auditor needs control reliance. If controls are tested at an interim period, the auditor will also need to obtain audit evidence about the operating effectiveness of controls related to significant changes to those controls after the interim period and determine the additional audit evidence to be obtained for the remaining period.

It is possible to use evidence of tests of controls performed in previous audits. The auditor will consider:

- a. The effectiveness of other elements of internal control, including the control environment, the entity's monitoring of controls, and the entity's risk assessment process.
- b. The risks inherent in the control (automated vs. manual), including whether the control is manual or automated.
- c. The effectiveness of general IT controls.
- d. The effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control noted in previous audits and whether there have been personnel changes that significantly affect the application of the control.
- e. Whether the lack of a change in a particular control poses a risk due to changing circumstances.
- f. The risks of material misstatement and the extent of reliance on the control.

If the auditor decides to use the audit evidence from a previous audit, they should perform procedures to establish the continuing relevance of that information to the current audit. The auditor should obtain this evidence by performing inquiry, combined with observation or inspection, to confirm the understanding of those specific controls and if there have been changes that affect how relevant the controls would be to the current audit, those should be tested as well. Even if there have not been any significant changes the auditor still needs to test the controls at least once in every third audit and should test some controls during each audit. If the auditor decides to test control that are identified as a significant risk, then those should be tested in the current period.

## **B. Determining the effect of control testing on the remainder of the audit**

The auditor will review the results of the tests of internal controls and determine whether the controls are effective. In addition, when evaluating the operating effectiveness of controls, the auditor should consider whether misstatements that have been detected by substantive procedures that would indicate that controls are not operating effectively. The auditor will want to make inquiries to understand why the misstatement occurred and consider their consequences on the amount of substantive evidence obtained given the auditor's assumption of reliable controls when the sample was selected. The auditor may not have sufficient evidence. The appropriate response may be additional tests of controls to pinpoint the issue or additional substantive tests.

## ***IV. Evaluating the sufficiency and appropriateness of audit evidence***

Once the audit is complete the engagement partner should evaluate whether there is sufficient appropriate audit evidence to support their opinion. The partner exercises professional judgment in this regard.

It is influenced by such factors as:

- a. The significance of the potential misstatement in the relevant assertion and the likelihood of its having a material effect, individually or aggregated with other potential misstatements, on the financial statements.
- b. Effectiveness of management's responses and controls to address the risks.
- c. Experience gained during previous audits with respect to similar potential misstatements.
- d. Results of audit procedures performed, including whether such audit procedures identified specific instances of fraud or error.
- e. Source and reliability of the available information.
- f. Persuasiveness of the audit evidence.
- g. Understanding of the entity and its environment, including its internal control.

As noted earlier, an audit of financial statements is a cumulative and iterative process. Audit evidence obtained during the audit may cause the auditor to modify the nature, timing, or extent of other planned audit procedures if it contradicts the risk assessments made during the planning process. The auditor may also identify an unanticipated risk of fraud. This can happen during tests of controls, substantive testing or when performing final analytical procedures. It is important not to let these deviations from what the auditor expected get lost in the workpapers.

## **A. Stand-back requirement**

SAS 145, the revision to the risk assessment standard, provides for what is referred to as a stand-back requirement. SAS 145 amends AU-C 330 on performing procedures and evaluating the results obtained. AU-C section 330 now requires the auditor to perform substantive procedures for each relevant assertion of each significant class of transactions, account balance, and disclosure, regardless of the assessed level of control risk.

The stand-back requirement focuses on an evaluation of the completeness of the identification of significant classes of transactions, account balances, and disclosures by the auditor. There may be material classes of transactions, account balances, or disclosures that have not been determined to be significant classes of transactions, account balances, or disclosures because there are no relevant assertions. The new guidance requires the auditor to evaluate whether their determination remains appropriate.

## **B. Quality management SAS in exposure draft**

Recently, the Auditing Standards Board issued standards to improve the current quality control standards. The suite of quality management standards contains SQMS 1, 2, and 3; SAS 146; SAS 149; and SSARS 26. The quality management (QM) standards focus on tailoring the firm's system of quality management to the size and complexity of the firm along with its engagements. SQMS 1 contains a risk-based approach to quality management, and SQMS 2 contains guidance for the Engagement Quality Review. SQMS 3 contains guidance for audits of group financial statements. The QM SAS deals with quality at the engagement level with an effective date for periods beginning on or after December 15, 2025.

SAS 146 states that the engagement partner needs to be sufficiently and appropriately involved throughout the engagement. This is fundamental to providing the engagement leadership required to achieve high-quality audits and, therefore, to meeting the objective of SAS 146. The engagement partner's responsibility to manage and achieve quality on the engagement is demonstrated through sufficient and appropriate involvement throughout the engagement to ensure that the significant

judgments made and the conclusions reached are appropriate given the nature and circumstances of the audit.

The partner's responsibility includes:

- a. Fulfilling leadership responsibilities, including taking actions to create an environment for the engagement that emphasizes the firm's culture and the expected behavior of engagement team members.
- b. Assigning procedures, tasks, or actions to other members of the engagement team.
- c. Supporting engagement performance, including taking responsibility for the nature, timing, and extent of the direction, supervision, and review of the work performed.
- d. A "stand-back" requirement to determine whether they have taken overall responsibility for managing and achieving quality, including determining their involvement has been sufficient and appropriate throughout the engagement considering the nature and circumstances of the engagement.

### **C. Documentation**

Audit documentation is very important in all audits but particularly where new audit techniques are used. It is highlighted by the AICPA as an important component of SAS 142. However, AU-C 230 was not amended as a result of the standard.

As in all audits, the auditor should prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit:

- a. To understand the nature, timing, and extent of the audit procedures performed to comply with professional and legal requirements; and
- b. To understand the results of the audit procedures performed, and the audit evidence obtained.

This includes documentation of the audit strategy and the audit plan.

Documentation should include discussion of instances where significant findings or issues arose during the audit, the conclusions reached about those issues, and significant professional judgments made in reaching those conclusions.

The auditor should document:

- a. The identifying characteristics of the specific items or matters tested;
- b. Who performed the audit work and the date such work was completed; and,
- c. Who reviewed the audit work performed and the date and extent of such review.

Abstracts or copies of significant contracts or agreements should be included in the workpapers. The auditor should document discussions of significant findings or issues with management, those charged with governance, and others, including the nature of the significant findings or issues discussed, and when and with whom the discussions took place.

Since audit data analytics can yield results that are different from recorded balances, SAS 142 specifically highlights the need to document areas where these discrepancies occur, the auditor's investigation of those instances, and how the auditor addressed the inconsistency.

As discussed earlier, the audit is iterative and it is important to ensure that any changes due to additional significant findings identified during the audit are considered and reflected as necessary in the audit strategy and audit plan.

**1. Test Yourself questions 5 and 6 – True or false**

- |   |
|---|
| <ol style="list-style-type: none"><li>5. SAS 145 requires the audit partner to “stand back” and reevaluate the risk of fraud to ensure that the appropriate procedures were performed.</li><li>6. The audit evidence standard has extensive coverage on how to audit blockchain and robotic process automation.</li></ol> |
|---|

## ***V. Answers to Test Yourself questions***

- |    |        |
|----|--------|
| 1. | True.  |
| 2. | False. |
| 3. | False. |
| 4. | True.  |
| 5. | False. |
| 6. | False. |

