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PREFACE

The AICPA’s Clarity Project

Background

Following the creation of the Public Company Accounting Oversight Board (PCAOB), the AICPA’s Auditing Standards Board (ASB) reassessed its mission. The ASB developed a plan to converge US generally accepted auditing standards (GAAS) with the International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board (IAASB). Thus, the ASB’s Clarity Project began work to:

• Redraft the auditing standards for clarity—to make the standards easier to read, understand, and apply
• Converge US standards with the ISAs

The ASB is close to completing its project, and the new clarified standards are generally effective for audits of financial statements with periods ending on or after December 15, 2012. For legal and practice inspection purposes, the ASB decided early adoption was not appropriate. However, auditors may implement aspects of the new standards as long as they also comply with the current standards.

While clarity and convergence, not change, were the goals of the Clarity Project, the Project did create some changes that require auditors to make changes in practice. For ease of use this book arranges information according to the sections of the AICPA’s auditing standards codification.

Wiley GAAS, Format of the Clarified Standards

To align with the IAS format and to provide clarity for auditors, each of the clarity standards presents requirements in this format:

• Introduction—explains the purpose and scope of the standard
• Objectives—defines the context in which the requirements are set
• Definitions—explains, where relevant, specific terms
• Requirements—what the auditor must do to meet the objectives of the standard
• Application and Other Explanatory Matters—provide further guidance for carrying out the requirements of the standard

Where relevant, the standards may include guidance relevant to audits of smaller, less complex entities and governmental entities.

Clarified Standards Issued to Date

Statement on Auditing Standards (SAS) No. 122 contains the vast majority of the clarified guidance. SAS Nos. 117–121 were issued in advance of SAS No. 122 due to pressing practice needs. Others were delayed for varying reasons. The ASB has issued the following clarified standards:

• SAS No. 117, Compliance Audits, is effective for compliance audits for periods ending on or after December 15, 2010.
• SAS No. 118, Other Information in Documents Containing Audited Financial Statements, is effective for audits of financial statements for periods beginning on or after December 15, 2010.
• SAS No. 119, *Supplementary Information in Relation to the Financial Statements as a Whole*, is effective for audits of financial statements for periods beginning on or after December 15, 2010.
• SAS No. 120, *Required Supplementary Information*, is effective for audits of financial information for periods beginning on or after December 15, 2010.
• SAS No. 121, *Revised Applicability of Statement on Auditing Standards No. 100, Interim Financial Information*.
• SAS No. 122, *Codification of Auditing Standards and Procedures*. When the AICPA recodified auditing standards in 1972, it reissued all standards as SAS No. 1. This did not happen with the Clarity Project.
• SAS No. 123, *Omnibus Statement on Auditing Standards—2011*, is effective for audits of financial statements for periods ending on or after December 15, 2012. This statement conformed SAS Nos. 117–118 to the clarity standards and made other changes necessitated by the clarity project.
• SAS No. 125, *Alert That Restricts the Use of the Auditor’s Written Communication*.
• SAS No. 126, *The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern*, is effective for audits of financial statements for periods ending on or after December 15, 2012. The ASB delayed issuance of clarified going concern guidance because of the Financial Accounting Standards Board (FASB) going concern project. Recently, however, FASB divided the project into two separate and distinct phases. As a result, FASB issued in 2013 an Accounting Standards Update that addresses Phase 1, “The Liquidation Basis of Accounting,” June 2013, and to issued an Exposure Draft that addresses Phase II, “Going Concern,” in the fourth quarter of 2012. Therefore, the ASB went ahead and released a clarified version of AU-C 570.
• Open project—as of December 2013, the ASB has one topic remaining to be clarified: AU Section 322 and Section 610, The Auditor’s Consideration of the Internal Audit Function in an Audit of Financial Statements. The AICPA issued an exposure draft in July 2013.

The AICPA has categorized the clarified standards into four groups based on the type of change:

• *Substantive Changes*—expected to affect audit methodology and engagements
• *Primarily Clarifying Changes*—intended to explicitly state what may have been implicit in the previous standards, which over time resulted in diversity in practice. These changes may affect timing and responsibilities of the auditor.
• *Primarily Formatting Changes*—changes that do not expand the previous sections in any significant way and may not require adjustments to current practice
• *Standards Not Yet Issued in the Clarity Project*—as mentioned previously, there is only one standard not yet issued

**Areas Substantially Unchanged by the Clarity Standards**

The broad areas that have not been changed substantially by the clarified standards are:

• Audit documentation
• Auditor’s communication with those charged with governance
• Risk assessment standards
Areas Substantially Changed by the Clarity Standards

Substantive changes are likely to change audit methodology and engagements. The areas that have been changed substantially by the clarified standards are:

- Illegal acts by clients
- Communicating internal control related matters identified in an audit
- Related parties
- Adherence to generally accepted accounting principles (GAAP)
- The auditor’s report
- Dating of an independent auditor’s report
- Part of an audit performed by other independent auditors (group audits)

Organization

The previous codification was arranged by the ten general, fieldwork, and reporting standards. These standards are superseded in the clarified standards. In their place, each clarified standard has objectives. These objectives provide a link to the overall objective of the auditor. If the auditor fulfills the objectives and the ethical requirements, then the auditor will have fulfilled the requirements stated in the ten standards.

The codification based on the clarified standards generally follows the ISA categories. These are the broad categories of the clarified codification:

- AU-C 200–299 General Principles and Responsibilities
- AU-C 300–499 Risk Assessment and Response to Assessed Risk
- AU-C 500–599 Audit Evidence
- AU-C 600–699 Using the Work of Others
- AU-C 700–799 Audit Conclusions and Reporting
- AU-C 800–899 Special Considerations
- AU-C 900–999 Special Considerations in the United States

Resources

Wiley GAAS contains robust tools to help auditors implement the clarified standards. Each chapter begins with the status of the code section the clarified objectives and definitions. Exhibits and illustrations are integrated in the chapter and clearly identified. Clarified standard references are preceded by “AU-C,” and the AICPA Auditing Standards Board has decided to retain the “AU-C” designation indefinitely.

The AICPA mapping of the previous standards to the clarified standards, ASB Clarity Project: Extant AU Sections Mapped to the Clarified AU-C Sections is included as Appendix A.

The AICPA has dedicated a page on its site with links to additional resources that may be helpful in implementing the changes:

http://www.aicpa.org/InterestAreas/FRC/AuditAttest/Pages/ImprovingClarityASBStandards.aspx
ABOUT THE AUTHOR

Joanne M. Flood, CPA, is an author and independent consultant on accounting and auditing technical topics and e-learning. She has experience as an auditor in both an international firm and a local firm and worked as a senior manager in the AICPA’s Professional Development group. She received her MBA Summa Cum Laude in Accounting from Adelphi University and her Bachelor’s degree in English from Molloy College.

While in public accounting, Joanne worked on major clients in retail, manufacturing, and finance and on small business clients in construction, manufacturing, and professional services. At the AICPA, Joanne developed and wrote e-learning, text, and instructor-led training courses on US and International Standards. She also produced training materials in a wide variety of media, including print, video, and audio, and pioneered the AICPA’s e-learning product line. Joanne resides on Long Island, New York with her daughter, Elizabeth. Joanne is the author of the following:

Financial Disclosure Checklist
Wiley GAAP 2014: Interpretation and Application of Generally Accepted Accounting Principles
Wiley Practitioner’s Guide to GAAS 2014: Covering all SASs, SSAEs, SSARSs, and Interpretations

Contributor, 2014 Interpretation and Application of International Financial Reporting Standards
This book reduces the official language of Statements on Auditing Standards (SASs), Statements on Standards for Attestation Engagements (SSAEs), Statements on Standards for Accounting and Review Services (SSARSs), Public Company Accounting Oversight Board (PCAOB) Auditing Standards, and the interpretations of those standards into easy-to-read and understandable advice. It is designed to help CPAs in the application of, and compliance with, authoritative standards. Because this year marks the transition to the clarified standards resulting from the AICPA’s Clarity Project, references to the extant standards include “AU,” while references to the clarified standards include “AU-C.” It is important to refer to the Preface for additional information.

This book follows the sequence of sections of the AICPA Codification of Statements on Auditing Standards, the Codification of Statements on Standards for Attestation Engagements, and the Codification of Statements on Standards for Accounting and Review Services. Sections are divided into the following easy-to-understand parts:

**Effective Date and Applicability.** A handy, brief identification of the original standard for the section, its effective date, and the circumstances that require the application of the section.

**Definitions of Terms.** A glossary of official definitions that gathers in one place explanations of terms that are ordinarily scattered throughout a standard.

**Objectives of Section.** A behind-the-scenes explanation of the reasons for the pronouncement and a capsule explanation of the most basic ideas of the section.

**Fundamental Requirements.** Concise listing and descriptions of those things specifically mandated by the section.

**Interpretations.** A brief summary of each interpretation.

**Techniques for Application.** Helpful techniques for complying with the fundamental requirements of the section.

**Illustrations.** Examples of the application of the fundamental requirements of the section.

Selected AICPA Practice Alerts and Audit Issues Task Force Advisories have also been summarized in certain sections.

As with all accounting and auditing publications, this book is merely a guide. It is not a substitute for professional judgment. It can, however, be a valuable reference tool.

The 2013 edition of this book is current through SAS 126, *The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern*; SSAE 17, *Reporting on Compiled Prospective Financial Statements When the Practitioner’s Independence is Impaired*; and SSARS 20, *Revised Applicability of Statements on Standards for Accounting and Review Services*; as well as the most recent PCAOB Auditing Standard 15, *Audit Evidence.*

Joanne M. Flood
August 2012
AU-C 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards

AU-C EFFECTIVE DATE AND APPLICABILITY

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NOTE: All sections apply whether the financial statements are presented in conformity with generally accepted accounting principles (GAAP) or other comprehensive basis of accounting (OCBOA) unless otherwise noted.

AU-C 200 DEFINITIONS OF TERMS

Source: AU-C 200.14

**Applicable financial reporting framework.** The financial reporting framework adopted by management and, when appropriate, those charged with governance in the preparation and fair presentation of the financial statements, that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation.

**Audit evidence.** Information used by the auditor in arriving at the conclusions on which the auditor’s opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information. *Sufficiency of audit evidence* is the measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor’s assessment of the risks of material misstatement and also by the quality of such audit evidence. *Appropriateness of audit evidence* is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor’s opinion is based.

**Audit risk.** The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risk of material misstatement and detection risk.
Auditor. The term used to refer to the person or persons conducting the audit, usually the engagement partner or other members of the engagement team, or, as applicable, the firm. When an AU-C section expressly intends that a requirement or responsibility be fulfilled by the engagement partner, the term engagement partner rather than auditor is used. Engagement partner and firm are to be read as referring to their governmental equivalents when relevant.

Detection risk. The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

Financial reporting framework. A set of criteria used to determine measurement, recognition, presentation, and disclosure of all material items appearing in the financial statements; for example, U.S. generally accepted accounting principles, International Financial Reporting Standards (IFRSs) promulgated by the International Accounting Standards Board (IASB), or a special purpose framework.

The term fair presentation framework is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and

1. Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or
2. Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

A financial reporting framework that requires compliance with the requirements of the framework but does not contain the acknowledgments in 1 or 2 is not a fair presentation framework.

Financial statements. A structured representation of historical financial information, including related notes, intended to communicate an entity’s economic resources and obligations at a point in time or the changes therein for a period of time in accordance with a financial reporting framework. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information. The term financial statements ordinarily refers to a complete set of financial statements as determined by the requirements of the applicable financial reporting framework, but can also refer to a single financial statement.

Historical financial information. Information expressed in financial terms regarding a particular entity, derived primarily from that entity’s accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.

Interpretive publications. Auditing interpretations of generally accepted accounting standards (GAAS), exhibits to GAAS, auditing guidance included in the American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guides, and the AICPA Auditing Statements of Position (SOPs).

Management. The person(s) with executive responsibility for the conduct of the entity’s operations. For some entities, management includes some or all of those charged with governance; for example, executive members of a governance board or an owner-manager.
Misstatement. A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be presented fairly in accordance with the applicable financial reporting framework. Misstatements can arise from fraud or error.

Other auditing publications. Publications other than interpretive publications; these include AICPA auditing publications not defined as interpretive publications; auditing articles in the Journal of Accountancy and other professional journals; continuing professional education programs and other instruction materials, textbooks, guide books, audit programs, and checklists; and other auditing publications from state certified public accountant (CPA) societies, other organizations, and individuals.

Premise, relating to the responsibilities of management and, when appropriate, those charged with governance, on which an audit is conducted (the premise). Management and, when appropriate, those charged with governance have acknowledged and understand that they have the following responsibilities that are fundamental to the conduct of an audit in accordance with GAAS; that is, responsibility

1. For the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework;
2. 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; and
3. To provide the auditor with
   a. Access to all information of which management and, when appropriate, those charged with governance are aware that is relevant to the preparation and fair presentation of the financial statements, such as records, documentation, and other matters;
   b. Additional information that the auditor may request from management and, when appropriate, those charged with governance for the purpose of the audit; and
   c. Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

The premise, relating to the responsibilities of management and, when appropriate, those charged with governance, on which an audit is conducted may also be referred to as the premise.

Professional judgment. The application of relevant training, knowledge, and experience within the context provided by auditing, accounting, and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement.

Professional skepticism. An attitude that includes a questioning mind, being alert to conditions that may indicate possible misstatement due to fraud or error, and a critical assessment of audit evidence.

Reasonable assurance. In the context of an audit of financial statements, a high, but not absolute, level of assurance.

Risk of material misstatement. The risk that the financial statements are materially misstated prior to the audit. This consists of two components, described as follows at the assertion level:
• **Inherent risk.** The susceptibility of an assertion about a class of transaction, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

• **Control risk.** The risk that a misstatement that could occur in an assertion about a class of transaction, account balance, or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity’s internal control.

**Those charged with governance.** The person(s) or organization(s) (for example, a corporate trustee) with responsibility for overseeing the strategic direction of the entity and the obligations related to the accountability of the entity. This includes overseeing the financial reporting process. Those charged with governance may include management personnel; for example, executive members of a governance board or an owner-manager.

### OBJECTIVES OF AU-C SECTION 200

AU-C Section 200.12 states that:

... The overall objectives of the auditor, in conducting an audit of financial statements, are to

a. obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with an applicable financial reporting framework; and

b. report on the financial statements, and communicate as required by GAAS, in accordance with the auditor’s findings.

### FUNDAMENTAL REQUIREMENTS

**Objective of Ordinary Audit**

The purpose of an audit is to provide users with an opinion by the auditor on the fairness, in all material respects, with which the financial statements present financial position, results of operations, and cash flows in conformity with the applicable financial reporting framework. (AU-C 200.04)

**Auditor Responsibilities**

In every audit, the auditor has to obtain reasonable assurance† about whether the financial statements are free of material misstatement, whether due to errors or fraud. (AU-C 200.06)

Materiality is taken into account when planning and performing the audit. Misstatements are considered material when they influence economic decisions by financial

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† See Definitions of Terms.
Defining Professional Requirements in Statements on Auditing Standards

Materiality considers qualitative and quantitative elements and should be viewed in context. (AU-C 200.07)

The auditor’s overall objectives are not only to obtain reasonable assurance about whether the financial statements are free of material misstatement in order to form an opinion, but to issue a report and communicate as required by GAAS. (AU-C 200.12)

If reasonable assurance cannot be obtained, the auditor must either disclaim an opinion or withdraw, when possible. (AU-C 200.13)

**INDEPENDENCE**

The auditor must be independent. If not independent, the auditor cannot issue a report under GAAS. The only exception is if GAAS provides otherwise or law or regulation requires the auditor to accept the engagement and report on the financial statements (AU-C 200.15)

**PROFESSIONAL SKEPTICISM**

The auditor must perform the audit with professional skepticism and exercise professional judgment in planning and performing an audit of financial statements. (AU-C 200.17-18)

**MANAGEMENT RESPONSIBILITIES**

Financial statements are prepared by management with oversight from those charged with governance. GAAS do not impose requirements on management or those charged with governance. However, an audit is conducted on the premise that management and those charged with governance understand their responsibilities. (AU-C 200.05)

**DEFINING PROFESSIONAL REQUIREMENTS IN STATEMENTS ON AUDITING STANDARDS**

AU-C Section 200.25-26 clarifies that the SASs use two categories of professional requirements to describe the degree of responsibility the standards impose on auditors.

- **Unconditional requirements.** The auditor is required to comply with an unconditional requirement in all cases in which the circumstances exist to which the unconditional requirement applies. SASs use the words *must* to indicate an unconditional requirement.

- **Presumptively mandatory requirements.** The auditor is also required to comply with a presumptively mandatory requirement in all cases in which the circumstances exist to which the presumptively mandatory requirement applies; however, in rare circumstances, the auditor may depart from a presumptively mandatory requirement provided the auditor documents his or her justification for the departure and how the alternative procedures performed in the circumstances were sufficient to achieve the objectives of the presumptively mandatory requirement. SASs use the word *should* to indicate a presumptively mandatory requirement.
The term “should consider” means that the consideration of the procedure or action is presumptively required, whereas carrying out the procedure or action is not.

AU-C Section 200 also clarifies that explanatory material is intended to explain the objective of the professional requirements, rather than imposing a professional requirement for the auditor to perform.

**GAAS AND THE GAAS HIERARCHY**

The auditor is responsible for planning, conducting, and reporting the results of an audit according to GAAS.

Auditors are required to comply with Statements on Auditing Standards. Each SAS contains objectives that provide a link between the requirements and the overall objectives of the auditor. The SASs taken as a whole provide the standards for the auditor’s work in fulfilling his or her objectives. Auditors should have sufficient knowledge of the SASs to determine when they apply and should be prepared to justify departures from the SASs.

**Interpretive Publications**

Interpretive publications are recommendations, issued under the authority of the ASB, on how to apply the SASs in specific circumstances, including engagements for entities in specialized industries. Interpretive publications are not auditing standards. They consist of the following:

- Auditing Interpretations of SASs, listed in each chapter of this book that has a related Interpretation.
- AICPA Audit and Accounting Guides and Statements of Position, listed in Appendix C of this book.

(AU-C 200.A81)

Auditors should be aware of and consider interpretive publications that apply to their audits. Auditors who do not follow the guidance in an applicable interpretive publication should be prepared to explain how they complied with the relevant SAS requirements addressed by such guidance.

**Other Auditing Publications**

Other auditing publications are not authoritative but may help auditors to understand and apply SASs.

An auditor should evaluate such guidance to determine whether it is both (1) relevant for a particular engagement and (2) appropriate for the particular situation. When evaluating whether the guidance is appropriate, the auditor should consider whether the publication is recognized as helpful in understanding and applying SASs, and whether the author is recognized as an auditing authority. (AICPA auditing publications that have been reviewed by the AICPA Audit and Attest Standards staff are presumed to be appropriate.) (AU-C 200.A84)
INDEPENDENCE

To be independent, the auditor must be intellectually honest; to be recognized as independent, he or she must be free from any obligation to or interest in the client, its management, or its owners. For specific guidance, the auditor should look to AICPA and the state society codes of conduct and, if relevant, the requirements of the Securities and Exchange Commission (SEC).

PROFESSIONAL SKEPTICISM

The auditor should observe GAAS, possess the degree of skill commonly possessed by other auditors, and should exercise that skill with reasonable care and diligence. The auditor should also exercise professional skepticism, that is, an attitude that includes a questioning mind and a critical assessment of audit evidence. However, the auditor is not an insurer, and the audit report does not constitute a guarantee because it is based on reasonable assurance. Thus, an audit conducted in accordance with GAAS may not detect a material misstatement. The auditor should be alert to the possibility of collusion when performing the audit and how management may override controls in a way that would make the fraud particularly difficult to detect.

INTERPRETATIONS

There are no interpretations for this section.

TECHNIQUES FOR APPLICATION

MANAGEMENT’S RESPONSIBILITIES

Many times, clients do not understand their responsibilities for the audited financial statements. These financial statements are management’s. They contain management’s representations. The form and content of the financial statements are management’s responsibility, even though the auditor may have prepared them or participated in their preparation. The SEC has stated:

The fundamental and primary responsibility for the accuracy of information filed with the Commission and disseminated among the investors rests upon management. Management does not discharge its obligations in this respect by the employment of independent accountants, however reputable (Accounting Series Release No. 62; emphasis added).

Management also is responsible for implementing and maintaining an effective system of internal control.

2 Section 201 of the Sarbanes–Oxley Act of 2002 and the related SEC implementing rules created significant new independence requirements for auditors of public companies. For example, the SEC prohibits certain nonaudit services such as bookkeeping, internal audit outsourcing, and valuation services. All audit and nonaudit services performed by the auditor, including tax services, must be preapproved by the company’s audit committee. In March 2003, the SEC issued final rules implementing Section 201 of the Act. The rules, Strengthening the Commission’s Requirements Regarding Auditor Independence, can be found at www.sec.gov/rules/final/33-8183.htm.
AUDITOR’S RESPONSIBILITIES

The auditor’s responsibility for the financial statements he or she audits is confined to the expression of an opinion on those statements. In performing the audit, the auditor is responsible for compliance with GAAS, including the SASs.

Under the GAAS, the auditor has a responsibility to consider SASs and interpretive publications in all audits. If such guidance is not followed, an auditor must be prepared:

- For SASs, to justify a departure from SASs
- For interpretive publications, to explain that an alternative approach achieved the objectives of GAAS

To provide reasonable assurance that it is conforming with generally accepted auditing standards in its audit engagements, an accounting firm should establish quality control policies and procedures. These policies and procedures should apply not only to audit engagements but also to attest and accounting and review services for which professional standards have been established. (AU-C 200.A20)

Independence, Integrity, and Objectivity

Policies and procedures should provide reasonable assurance that personnel maintain independence when required and perform all responsibilities with integrity and objectivity.

1. Independence is an impartiality that recognizes an obligation for fairness.
2. Integrity pertains to being honest and candid, and requires that service and public trust not be subordinated to personal gain.
3. Objectivity is a state of mind that imposes an obligation to be impartial, intellectually honest, and free of conflicts of interest.
AU-C 210 Terms of Engagement

AU-C EFFECTIVE DATE AND APPLICABILITY

Original Pronouncement  Statement on Auditing Standards (SAS) 122
Effective Date  Standard is currently effective.
Applicability  Audits of financial statements in accordance with generally accepted auditing standards (GAAS).

APPLICABILITY

This section states the requirements and provides application guidance on the auditor’s responsibilities in agreeing upon terms of engagement. It establishes preconditions for an audit, for which management is responsible. AU-C 220 addresses those aspects of engagement acceptance that the auditor can control. AU-C 580, Written Representations, discusses management’s responsibilities.

DEFINITIONS OF TERMS

Source: AU-C 210.04

Preconditions for an audit. The use by management of an acceptable financial reporting framework in the preparation and fair presentation of the financial statements and the agreement of management and, when appropriate, those charged with governance, to the premise on which an audit is conducted.

Recurring audit. An audit engagement for an existing audit client for whom the auditor performed the preceding audit.

OBJECTIVES

AU-C Section 210.03 states that:

. . . the objective of the auditor is to accept an audit engagement for a new or existing audit client only when the basis upon which it is to be performed has been agreed upon through

a. establishing whether the preconditions for an audit are present and
b. confirming that a common understanding of the terms of the audit engagement exists between the auditor and management and, when appropriate, those charged with governance.
FUNDAMENTAL REQUIREMENTS

ENGAGEMENT ACCEPTANCE

PRECONDITIONS

Unless required to do so by law or regulation, an auditor should not accept an engagement when the preconditions (see “Definitions of Terms” section above) are not met. To assess whether those preconditions are met, the auditor should:

a. determine whether the financial reporting framework¹ to be applied in the preparation of the financial statements is acceptable and

b. obtain the agreement of management that it acknowledges and understands its responsibility

i. for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework;

ii. 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; and

iii. to provide the auditor with

(1) access to all information of which management is aware that is relevant to the preparation and fair presentation of the financial statements, such as records, documentation, and other matters;

(2) additional information that the auditor may request from management for the purpose of the audit; and

(3) unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

(AU-C 210.06)

If management limits the scope of the auditor’s work so that the auditor will have to disclaim an opinion, the auditor should not accept the engagement. The exception to this is when management is required by law or regulation to have an audit and the disclaimer of opinion is acceptable under law or regulation, for example with audits of employee benefit plans. Then, the auditor can accept the engagement. (AU-C 210.07)

The auditor should establish an understanding with management or those charged with governance² about the services to be performed for each audit, review of a public company’s financial statements, or agreed-upon procedures engagement. The understanding should include:

1. The engagement’s objectives and scope
2. Management’s responsibilities
3. Auditor’s responsibilities

¹ Acceptable reporting frameworks contain established accounting principles promulgated by a body designated by the Council of the AICPA under Rule 203 in the AICPA Code of Professional Conduct. These bodies include FASB, FASAB, IFRS, GASB, AICPA, and PCAOB.

² In this chapter, references to management should be read as “management and, when appropriate, those charged with governance,” unless the context suggests otherwise. Those charged with governance are those “with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity,” including the financial reporting process. (AU-C 210.A20)
4. The audit’s limitations, the inherent limitations of internal control, and risk that some misstatements may not be detected
5. Financial reporting framework
6. Expected form and content of the report

The auditor should document the understanding, in writing. If the auditor fails to establish an understanding, the auditor should decline the engagement. (AU-C 210.09-.10)

A sample engagement letter is included at the end of this chapter.

**Initial Audits, Reaudits, and Recurring Audits**

Inquiry of the predecessor auditor is required because the predecessor may provide information that will assist the successor auditor in deciding whether to accept the engagement. The communication may be either written or oral. Both the predecessor and successor auditors should treat any information obtained from each other as confidential information.

The successor auditor should request permission from the prospective client to make an inquiry of the predecessor prior to final acceptance of the engagement. However, the successor auditor may make a proposal for an audit engagement before having permission to inquire of the predecessor auditor. The successor auditor should ask the prospective client to authorize the predecessor to respond fully to the successor auditor’s inquiries. If a prospective client refuses to permit the predecessor auditor to respond or limits the response, the successor auditor should inquire as to the reasons and consider the implications of that refusal in deciding whether to accept the engagement. (AU-C 210.11)

For a recurring audit, the auditor should evaluate whether the terms of the engagement need to be changed. The auditor should also remind the client about the existing terms of engagement. If the client requests a change in the terms, the auditor must ensure that there is a reasonable justification for the change. So, too, if prior to completion of an audit, the client requests a change to an engagement with a lower level of assurance, the auditor must be satisfied that a reasonable justification for doing so exists. If the terms are changed, the auditor and management should document the mutually agreed upon change in writing. (AU-C 210.13-16)

If, however, the auditor concludes there is no reasonable justification for a change in terms and management does not allow the auditor to continue the original audit, the auditor must take these steps:

1. Withdraw from the engagement
2. Communicate the situation to those charged with governance
3. Determine whether the auditor has any legal, contractual, or other obligation to report the circumstances to owners, regulators, or other parties.

(AU-C 210.17)

**INTERPRETATIONS**

There are no interpretations for this section.
TECHNIQUES FOR APPLICATION

Engagement Letter

In addition to the engagement letter guidance discussed earlier, the auditor may want to:

1. Elaborate on the audit objectives by referencing regulations, laws, GAAS, ethical codes, pronouncements of professional bodies, as applicable.
2. Identify any communications in addition to the auditor’s report
3. Remind management about the expectation of a management letter, the agreement to make available draft financial statements on a timely basis, the agreement for management to inform the auditor of subsequent events that may affect the financial statements
4. Detail fees and billing arrangements
5. Request management to acknowledge receipt of the engagement letter and to agree to the terms by signing the letter.

The auditor may also choose to address arrangements concerning the involvement of other auditors, specialists, internal auditors and other entity staff, and predecessor auditors. Restrictions on auditor’s liability, when not prohibited, audit documentation to be provided to other parties, additional services, and any other agreements with the entity may be included in the engagement letter. (AU-C 210.A23-.A26)

INQUIRIES OF THE PREDECESSOR AUDITOR

The successor auditor should make specific and reasonable inquiries of the predecessor about:

1. Information about management’s integrity
2. Disagreements with management about accounting principles, auditing procedures, or other similarly significant matters
3. Communications to those charged with governance and responsibility regarding fraud, noncompliance with laws or regulations, and internal control-related matters
4. The predecessor auditor’s understanding concerning the reasons for the change of auditors (AU-C 210.A31)

The predecessor auditor should respond promptly, fully, and factually. However, if the predecessor decides, due to unusual circumstances such as impending, threatened, or potential litigation; disciplinary proceedings; or other unusual circumstances, not to respond fully, he or she should indicate that the response is limited. (AU-C 210.A30) Also, if more than one auditor is considering accepting the audit, the predecessor audit does not have to respond to inquiries until an auditor has been selected by the entity and accepted the engagement. (AU-C 210.A28)

If the successor auditor receives a limited response, that auditor should consider the implications of the limited response in deciding whether to accept the engagement.