100-230 THE AUDITOR'S RESPONSIBILITIES AND FUNCTIONS, INTRODUCTION TO GAAS, AND THE GENERAL STANDARDS (INCLUDING THE QUALITY CONTROL STANDARDS)

EFFECTIVE DATE AND APPLICABILITY

Original Pronouncements	Statement of Auditing Standards (SAS) 1, 5, 25, 41, 43, 78, 82, 95, 98, 99, 102, 104, 105, and 113.
Effective Date	All standards currently are effective.
Applicability	All audits in accordance with generally accepted auditing standards and other services covered by SASs.

NOTE: All sections apply whether the financial statements are presented in conformity with GAAP or OCBOA unless otherwise noted.

DEFINITIONS OF TERMS

Auditing procedures. Acts to be performed by the auditor during the course of an audit to comply with auditing standards.

Auditing standards. Measures of audit quality and the objectives to be achieved in an audit.

Practitioner-in-charge. An individual responsible for supervising an audit engagement or signing the report on such an engagement.

Professional skepticism. An attitude that includes a questioning mind and a critical assessment of audit evidence.

Reasonable assurance. A high, but not absolute, level of assurance.

OBJECTIVES OF SECTIONS 100-230

Sections 100 through 230 clarify the difference between the responsibilities of the auditor and management, the nature of auditing standards, and their relationship to quality control standards. The Sections also provide guidelines for the training, independence, and proficiency of the independent auditor, as well as the level of professional care (including the use of professional skepticism and reasonable assurance) required in the performance of audit work.

FUNDAMENTAL REQUIREMENTS

OBJECTIVE OF ORDINARY AUDIT

To express an opinion on the fairness, in all material respects, with which the financial statements present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.

AUDITOR RESPONSIBILITIES

In every audit, the auditor has to obtain reasonable assurance about whether the financial statements are free of material misstatement. Material misstatement includes

1. Material error. (See Section 312)
2. Material fraud. (See Section 316)
3. Illegal acts by clients. (See Section 317)

MANAGEMENT RESPONSIBILITIES

The fairness of the representations made through financial statements is an implicit and integral part of management's responsibility. Management is responsible for

1. Adopting sound accounting policies.
2. Establishing and maintaining internal control that will, among other things, record, process, and report financial data that are consistent with management's assertions embodied in the financial statements.

The auditor's participation in preparing financial statements does not change the character of the statements as representations of management. In brief, management is responsible for the financial statements; the auditor is responsible for expressing an opinion on those financial statements.

DEFINING PROFESSIONAL REQUIREMENTS IN STATEMENTS ON AUDITING STANDARDS

AU Section 120 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** or **is required** 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 Section 120 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.

GENERALLY ACCEPTED AUDITING STANDARDS (GAAS) AND THE GAAS HIERARCHY

The auditor is responsible for planning, conducting, and reporting the results of an audit according to generally accepted auditing standards (GAAS). The hierarchy of GAAS consists of the following three tiers:

Tier 1: Auditing Standards (which include the Statements on Auditing Standards).[1]
Tier 2: Interpretive publications.
Tier 3: Other auditing publications.

Tier 1: Auditing Standards[1]

Tier 1 consists of (1) the ten general, fieldwork, and reporting standards, and (2) the Statements on Auditing Standards (SASs). As stated in AU 150.02 the generally accepted auditing standards (GAAS) approved by the American Institute of Certified Public Accountants (AICPA) membership are

A. General Standards

1. **Training and proficiency.** The audit must be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. **Independence.** In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
3. **Due care.** Due professional care is to be exercised in the planning and performance of the audit and the preparation of the report.

B. Fieldwork Standards

4. **Planning and supervising.** The auditor must adequately plan the work and must supervise any assistants.
5. **The entity and its environment, including its internal control.** The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements due to error or fraud and to design the nature, timing, and extent of further audit procedures.
6. **Evidential matter.** The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.

[1] *AICPA has designated the PCAOB as a body to promulgate auditing and related professional practice standards relating to the preparation and issuance of audit reports of issuers.*

C. Reporting Standards

7. **GAAP.** The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.
8. **Consistency.** The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.
9. **Disclosure.** Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
10. **Reporting obligation.** The report shall contain either an expression of opinion regarding the financial statements taken as a whole or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain

    a. A clear-cut indication of the character of the auditor's work, if any.
    b. The degree of responsibility the auditor is taking.

NOTE: Materiality and audit risk underlie the application of the ten standards and the SASs (see Section 312).

The preceding ten formal standards apply to all other services covered by SASs unless they are clearly not relevant or the SAS specifies that they do not apply.

These ten general, fieldwork, and reporting standards provide the framework for the SASs promulgated by the Auditing Standards Board (ASB). Auditors are required under Rule 202, *Compliance with Standards,* of the AICPA Code of Professional Conduct to comply with these standards. Auditors should have sufficient knowledge of the SASs to determine when they apply and should be prepared to justify departures from the SASs.

Tier 2: 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.
- Auditing guidance in AICPA Audit and Accounting Guides.
- Auditing Statements of Positions.
- Appendixes to the SASs.

NOTE: SAS 95 notes that certain "previously issued appendices to original pronouncements" that modified other SASs are Tier 1 publications, not interpretative publications.

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.

Tier 3: Other Auditing Publications

Other auditing publications are not authoritative but may help auditors to understand and apply SASs. Such publications include all AICPA auditing publications not included under Tier 1 or Tier 2 and other auditing publications, including

- Auditing articles in professional journals, such as the *Journal of Accountancy*
- Continuing professional education programs and other instructional materials
- Textbooks and guidebooks
- Audit programs and checklists
- Other auditing publications from state CPA societies, other organizations, and individuals

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.)

NOTE: Some of the most important Tier 3 publications are AICPA PITF Practice Alerts. All auditors of public companies should be familiar with these. A list of all Practice Alerts is included in Appendix C.

Quality Control Standards

An audit firm should establish a quality control system to provide it with reasonable assurance that its staff meets the requirements of GAAS in its audit engagements. The nature of this system depends on such factors as an audit firm's size, the nature of its practice, its organizational structure, the degree of autonomy allowed its personnel and office, and cost-benefit considerations.

Training and Proficiency of the Independent Auditor

The auditor holds out himself or herself as being proficient in accounting and auditing. Attaining proficiency begins with formal education and continues through later experience. The auditor must be aware of and understand new authoritative pronouncements on accounting and auditing.

Independence[2]

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 rules of conduct and, if relevant, the requirements of the Securities and Exchange Commission (SEC).

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[2] *Section 201 of 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.*

DUE PROFESSIONAL CARE IN THE PERFORMANCE OF WORK

The auditor should observe the standards of fieldwork and reporting, 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 generally accepted auditing standards 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.

Management Representation Letter

Generally accepted auditing standards require the auditor to obtain a management representation letter (see Section 333). In the letter, management acknowledges its responsibility for the financial statements and states its belief that the financial statements are fairly presented in conformity with generally accepted accounting principles. Sometimes, the client objects to this acknowledgment because of the auditor's role in the preparation of the financial statements. To avoid this misunderstanding, the auditor's engagement letter may include a paragraph such as the following:

> Generally accepted auditing standards require that we obtain from you a representation letter about the financial statements and the underlying accounting records and an acknowledgment that the financial statements are management's responsibility, and that they are presented in accordance with generally accepted accounting principles.

The annual reports of many public companies contain statements acknowledging management's responsibility for the financial statements and the underlying accounting records.

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 generally accepted auditing standards, including the statements on auditing standards.

Under the GAAS hierarchy, 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 to

- For Tier 1 SASs, justify a departure from SASs.
- For Tier 2 interpretive publications, explain that an alternative approach achieved the objectives of GAAS.

In other words, the first two categories of GAAS are "must know." When applying the Tier 3 level of GAAS, other auditing publications, the auditor should determine whether such guidance is relevant and appropriate.

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.

ESTABLISHMENT OF QUALITY CONTROL POLICIES AND PROCEDURES

The nature and extent of a firm's quality control policies and procedures depend on the following:

1. Firm size and the number of its offices.
2. The degree of autonomy of personnel and practice offices.
3. The knowledge and experience of its personnel.
4. The nature and complexity of the firm's practice.
5. The cost of developing and implementing quality control policies and procedures in relation to the benefits provided.

When a firm establishes quality control policies and procedures, it also should do the following:

1. Assign responsibilities to qualified personnel to implement quality control policies and procedures.
2. Communicate quality control policies and procedures to personnel (see below).
3. Monitor the effectiveness of the quality control system. The purpose is to determine that policies and procedures and the methods of implementing and communicating them are still appropriate.

NOTE: Flaws in, or a violation of, a firm's quality control do not necessarily indicate that an audit was not performed in accordance with GAAS.

ELEMENTS OF QUALITY CONTROL

When a firm establishes its quality control policies and procedures, it should follow the five elements of quality control (see Statement on Quality Control Standard 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice,* as amended by

SQCS 4, *Amendment to System of Quality Control for a CPA Firm's Accounting and Auditing Practice*).

NOTE: CPA firms or individuals that are enrolled in an AICPA approved practice-monitoring program are obligated to adhere to quality controls standards. In addition, the Principles of Professional Conduct indicate that members should practice in firms that have in place quality control procedures to provide reasonable assurance that services are competently delivered and adequately supervised. The Statements on Quality Control apply to a CPA firm's accounting, auditing, and attest practice.

Personnel Management

Policies and procedures should provide reasonable assurance that personnel

1. Have the characteristics to enable competent performance.
2. Have the technical training and proficiency needed.
3. Participate in continuing education to enable them to fulfill responsibilities and satisfy appropriate educational requirements of the AICPA and regulatory agencies.
4. Selected for advancement have the necessary qualifications.

Statement on Quality Control Standards 5, The Personnel Management Element of a Firm's System of Quality Control—Competencies Required by a Practitioner-in-Charge of an Attest Engagement, clarifies that a partner-in-charge of accounting, auditing, and attestation engagements should ordinarily

1. Understand the role of a system of quality control and the Code of Professional Conduct.
2. Understand the service to be performed
3. Be technically proficient.
4. Be familiar with the industry.
5. Exercise good professional judgment.
6. Understand the organization's information technology systems.

Firm policies and procedures should address other competencies necessary in the circumstances.

Acceptance and Continuance of Clients and Engagements

Policies and procedures should provide reasonable assurance that the firm will not be associated with clients whose management lacks integrity. A firm should

1. Undertake only engagements that can be completed with professional competence.
2. Consider the risks associated with the engagement.

Moreover, a firm should obtain an understanding with the client regarding the engagement.

Engagement Performance

Policies and procedures should provide reasonable assurance that personnel meet

1. Professional standards.
2. Regulatory requirements.
3. The firm's standards.
4. Concurring partner review requirements applicable to SEC engagements.

Policies and procedures should also provide reasonable assurance that personnel refer to authoritative literature and consult, on a timely basis, with appropriate individuals when dealing with complex, unusual, or unfamiliar issues.

Monitoring

Policies and procedures should provide reasonable assurance that the above elements of quality control are suitably designed and effectively applied. Monitoring involves

1. Relevant and adequate polices and procedures that are complied with by members of the firm.
2. Appropriate guidance and practice aids.
3. Effective professional development activities.

NOTE: A firm's monitoring procedures may include inspection procedures and preissuance or postissuance reviews of selected engagements by a qualified person not directly associated with performance of the engagement (which may be a partner with final responsibility for the engagement in a small firm) (see Statement on Quality Control Standard 3, ***Monitoring a CPA Firm's Accounting and Auditing Practice****).*

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.

ADMINISTRATION OF A QUALITY CONTROL SYSTEM

A partner or partners, depending on the size of the firm, should be responsible for monitoring the effectiveness of the firm's quality control system. The objective is to determine on a timely basis that the firm's quality control policies and procedures, assignment of responsibilities, and communication of policies and procedures continue to be appropriate.

ILLUSTRATIONS

The following chart illustrates the GAAS hierarchy.

ILLUSTRATION 1. GAAS HIERARCHY

Level	*Elements*	*Authority*
Tier 1 Auditing Standards	• 10 Formal Standards listed in *Fundamental Requirements* • Statements on Auditing Standards (SASs)	Auditors must be familiar with all guidance in this category. Any departures must be justified.
Tier 2 Interpretive Publications	• Auditing Interpretations of SASs • Auditing guidance in AICPA Audit and Accounting Guides • Auditing Statements of Position • Appendices to SASs	Auditors must be familiar with all guidance in this category. Any departures must be justified.
Tier 3 Other Auditing Publications	• AICPA auditing publications not referred to under Tier 1 or Tier 2, such as PITF Practice Alerts • Auditing articles in professional journals • Continuing professional education programs and other instructional materials • Textbooks and guidebooks • Audit programs and checklists • Other auditing publications from state CPA societies, other organizations and individuals	Guidance in this category is not authoritative. Auditors must determine whether guidance is appropriate and relevant in particular circumstances.