

AU-C 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards

AU-C ORIGINAL PRONOUNCEMENTS

Sources Statements on Auditing Standards (SASs) 122, 123, 128, and 130.

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, US 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, guidebooks, 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.*

If reasonable assurance cannot be obtained and a qualified opinion is insufficient, the auditor must either disclaim an opinion or withdraw from the engagement when possible under applicable law or regulation. (AU-C 200.13)

REQUIREMENTS

MANAGEMENT'S 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, but rather an audit is conducted on the premise that management and those charged with governance *understand* their responsibilities. (AU-C 200.05)

Many times clients do not understand their responsibilities for audited financial statements. The financial statements are *management's*. They contain management's representations. The form and content of the financial statements are management's responsibility, even if the auditor prepared them or participated in their preparation.

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

AUDITOR'S RESPONSIBILITIES

The auditor's responsibilities for the financial statements are confined to the expression of an opinion on the financial statements being audited. In performing the audit, the auditor is responsible for compliance with GAAS. Under GAAS, the auditor has a responsibility to consider AU-C sections and interpretive publications in all audits. If such guidance is not followed, an auditor must be prepared:

- For AU-C sections, to justify a departure from GAAS
- 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) The AICPA's Quality Control Standards detail the firm's responsibility for

establishing and maintaining a system of quality control for auditors. See QC Section 10, *A Firm's System of Quality Control*, for more information.

In every audit, the auditor has to obtain reasonable assurance¹ about whether the financial statements are free of material misstatement, whether due to errors or to fraud. (AU-C 200.06) Materiality is taken into account when planning and performing the audit. Misstatements are considered material, individually or in the aggregate, when they influence economic decisions made by financial statement users. Materiality considers qualitative and quantitative elements and should be viewed in context. (AU-C 200.07)

ETHICAL REQUIREMENTS

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)

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 the AICPA and the state society codes of conduct and, if relevant, the requirements of the Securities and Exchange Commission (SEC).²

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

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.

Due care requires the auditor to discharge professional responsibilities with the competence and diligence necessary to perform the audit and issue an appropriate report and to render services promptly, thoroughly, and carefully, while observing applicable standards.

(See the AICPA's Code of Professional Conduct, Section 300.)

PROFESSIONAL SKEPTICISM AND JUDGMENT

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) The auditor should:

- Observe GAAS,
- Possess the degree of skill commonly possessed by other auditors, and
- Exercise that skill with reasonable care and diligence.

¹ See *Definitions of Terms*.

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.

The auditor should also exercise *professional skepticism*, that is, *an attitude that includes a questioning mind and a critical assessment of audit evidence*.

In practice, this means that auditors should be alert for:

- Contradictory evidence,
- Indications of fraud,
- Unusual circumstances,
- Evidence that calls into question the reliability of documents and responses to inquiries,
- 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.

(AU-C 200.A22-A23)

However, the auditor is not an insurer, and the audit report does not constitute a guarantee. It is based on *reasonable assurance*. Thus, it is possible that an audit conducted in accordance with GAAS may not detect a material misstatement.

COMPLYING WITH GAAS

Auditors must comply with and understand AU-C sections. (AU-C 200.20 and .21) 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.

1. *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 word *must* to indicate an unconditional requirement.
2. *Presumptively mandatory requirements*. The auditor is also required to comply with a presumptively mandatory requirement in all circumstances where the presumptively mandatory requirement exists and applies. However, in rare circumstances, the auditor may depart from a presumptively mandatory requirement. The departure should only relate to a specific procedure when the auditors determine that the procedure would be ineffective in the specific circumstances. The auditors must document their justification for the departure and how the alternative procedures performed in the circumstances were sufficient to achieve the objectives of the presumptively mandatory requirement. GAAS use the word *should* to indicate a presumptively mandatory requirement.

(AU-C 200.25-.26)

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.³ GAAS provide the standards for the auditors' work in fulfilling their

³ Generally accepted auditing standards are issued in the form of Statements on Auditing Standards and codified into AU-C sections in the AICPA's Professional Standards.

objectives. Each AU-C section contains objectives that provide a link between the requirements and the overall objectives of the auditors. Auditors should have sufficient knowledge of the AU-C sections to determine when they apply and should be prepared to justify departures from them.

Interpretive Publications

Interpretive publications are not auditing standards, but 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 B of this book.

(AU-C 200.A81)

Auditors should consider interpretive publications that apply to their audits.

Other Auditing Publications

Other auditing publications, listed in Appendix C of this book, 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)

<http://www.pbookshop.com>