GAO
Accountability * Integrity * Reliability
United States Government Accountability Office
Washington, DC 20548

December 23, 2008

Ms. Sherry Hazel
Audit and Attest Standards
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

This letter provides the U.S. Government Accountability Office's (GAO) comments on the ASB's September 2008, Exposure Draft of the following:

- Proposed Preface to *Codification of Statements on Auditing Standards, Principles Governing an Audit Conducted in Accordance with Generally Accepted Auditing Standards*
- Proposed Statement on Auditing Standards, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards*

Overall, we support the proposed preface and standard, which appropriately summarize the fundamental principles that govern an audit and establish the auditor's overall responsibilities when conducting a financial statement audit in accordance with generally accepted auditing standards (GAAS).

The Board has asked respondents to comment on specific topics in addition to comments or suggestions on any other aspect of this exposure draft. We provide the requested comments and suggestions in this letter and recommend specific wording changes in the related attachment.

Comments on Specific Topics:

Question 1: Are the objectives to be achieved by the auditor, stated in the proposed SAS, appropriate?

Response: The objectives in paragraph 11 of the proposed SAS are appropriate but incomplete. As drafted, paragraph 11 accurately describes the overall objectives of the auditor in conducting such an audit; however, it does not describe the context in which the requirements of the proposed standard are set or serve to focus the auditor on the desired outcome of the relevant AU section. In addition, it does not explain that the overall objectives of the auditor in conducting an audit of financial statements and the auditor's objectives in complying with the requirements of this AU Section are the same. Finally, the format and structure of the objectives are not consistent with other redrafted SASs or the guidance presented in paragraph A70 of the proposed standard.

To present a more complete description of the overall objectives in conducting an audit as well as to align the objectives with the requirements and guidance of the proposed SAS and with the format and structure used in other redrafted SASs, we recommend revising paragraph 11 of the proposed standard. On page 17 of the attachment to this letter, we provide wording for such a revision.

Question 2: Are revisions from the existing standards to converge with ISA 200 appropriate?

Response: The proposed revisions to existing standards to converge with ISA 200 are generally appropriate. However, in the two areas noted below, we believe that the proposed revisions may not achieve the intended results.

First, we are concerned that the description of materiality in paragraph 6 of the proposed standard may lead auditors to interpret this concept too narrowly and to overlook considerations that are important, especially in audits of government and not-for-profit entities.

Extent AU Section 312.04 incorporates the definition of materiality from Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information.* By contrast, the proposed SAS includes the description of materiality from International Standard on Auditing (ISA) 200, which is consistent with International Accounting Standard (IAS) No. 1, *Presentation of Financial Statements.* These definitions and descriptions are included in the table below.

MATERIALITY DEFINITIONS/DESCRIPTIONS		
AU Section 312.04, and FASB Concepts Statement No. 2	**ISA 200, par. 6, and Proposed SAS, par. 6**	**IAS No. 1**
The magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.	In general, misstatements, including omissions, are considered to be material if, individually or in the aggregate, they could reasonably be expected to influence the **economic decisions** of users taken based on the financial statements. [**bolding** added for emphasis]	Omissions or misstatements of items are material if they could, individually or collectively, influence the **economic decisions** that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor. [**bolding** added for emphasis]

The IAS and ISA materiality descriptions include the phrase "economic decisions," which could be interpreted as reflecting just one sector of the marketplace, i.e., the commercial sector. These descriptions also appear to emphasize quantitative factors and do not mention qualitative materiality considerations that are important, especially in audits of government and not-for-profit entities.

We believe that the FASB/AU Section 312.04 definition is more appropriate for use in the proposed standard and in U.S. GAAS since it is market-sector neutral and allows for qualitative as well as quantitative considerations. However, since we support the ASB's efforts to minimize differences in core auditing standards and concepts, we have provided on pages 16 and 26 of the attachment to this letter minor wording changes to paragraphs 6 and A14, respectively, that would make the materiality description in the proposed standard relevant to a broader group of stakeholders.

Our second concern involves the inclusion in this standard of guidance related to audit evidence and audit risk. Specifically, paragraphs A31-A34 provide detailed guidance on the sufficiency and appropriateness of audit evidence that is more suitable to and may be duplicative of Proposed SAS 106 (Redrafted), *Audit Evidence.* Paragraphs A35-A47 include a comprehensive discussion of audit risk considerations that is more appropriate to and may be duplicative of the redrafted audit risk standards, SASs 107-110.

By separating the guidance for each of these important topics among AU sections, the context and full intent of the guidance may be lost. Conversely, organizing the application material for each topic in one AU section will provide for a more logical flow and offer more cohesive guidance for auditors. Accordingly, we recommend removing these paragraphs from the proposed SAS and including them in the SASs noted above.

Question 3: Are the differences between the proposed SAS and ISA 200 identified in the exhibit, and other language changes, appropriate?

Response: We believe that the differences between the proposed SAS and ISA 200 identified in the exhibit, and other language changes, are appropriate, except for Paragraph A4 of the proposed standard, which is not included in ISA 200. Paragraph A4 states that

> The auditor may make suggestions about the form or content of the financial statements, **or draft them, in whole or in part**, based on information from management during the performance of the audit. However, the auditor's responsibility for the audited financial statements is confined to the expression of the auditor's opinion on them. [**bolding** added for emphasis]

We are concerned that this wording appears to condone auditor preparation of financial statements without alerting auditors of the potential threats to auditor independence. The AICPA has adopted a risk-based conceptual framework for identifying and assessing threats to auditor independence and determining if such threats can be mitigated by adopting appropriate safeguards. The issue of drafting financial statements needs to be considered in the context of this threats and safeguards framework. Although the wording in paragraph A4 is taken from and would supersede AU Section 110.03, we strongly recommend removing the reference to drafting financial statements from the proposed standard.

Question 4: Have considerations for audits of smaller, less complex entities and governmental entities been dealt with appropriately?

While we believe that the considerations for audits of smaller, less complex entities and governmental entities included in the proposed SAS are appropriate, we have identified the following additional guidance related to audits of governmental entities that will further assist auditors in performing these engagements.

- The definition of financial statements on page 19 states that they are a "...structured representation of historical financial information..." We recommend adding a consideration for governmental entities stating that the applicable financial reporting framework for such entities may include statements that are other than historical and/or other than financial, such as statements of social insurance and/or stewardship information.

- Paragraph A8 lists GAAP and IFRS as fair presentation financial accounting frameworks. Indicating that U.S. fair presentation frameworks also include the frameworks established by the Federal Accounting Standards Advisory Board (FASAB) for Federal Government entities and by the Government Accounting Standards Board (GASB) for state and local government entities would provide important guidance to auditors of these entities.

- Paragraph A9 of the proposed standard provides examples of financial statements and the content of a complete set of financial statements appropriate for commercial enterprises. We recommended adding guidance on financial statements used by U.S. Federal Government entities and by U.S. state and local government entities.

- Paragraph A14 includes helpful materiality considerations specific to state and local governmental entities. We recommend including an additional discussion of the appropriateness of using lower materiality levels in audits of governmental entities due to the public accountability, visibility, and sensitivity of government programs. Paragraph 4.26b of *Government Auditing Standards*, July 2007 revision, discusses additional materiality considerations in an audit of government entities. We've incorporated that discussion, in part, in our proposed changes to paragraph A14.

We provide proposed wording for the inclusions on pages 25 and 26 of the attachment to this letter.

In addition, the ASB is seeking comments as to whether the discussion of the inherent limitations of an audit in the proposed SAS is balanced and appropriately located within the proposed SAS.

The discussion of the inherent limitations of an audit in paragraphs A48-A55 of the proposed SAS is appropriately balanced, but its placement in the standard does not provide for a logical flow of the guidance. Since the concept of inherent limitations of an audit is introduced in paragraph 5, the related guidance should be referenced to paragraph 5 and located between paragraphs A2-A13, which are referenced to paragraph 4, and paragraph A14, which is referenced to paragraph 6.

Suggestions for Improving Clarity

We recommend the following changes to improve the clarity of the proposed standard and thereby encourage consistency of practice:

- Revise paragraphs 18 and 19 to clearly articulate the requirement for auditors to obtain a sufficient understanding of GAAS to determine the AU sections that are relevant to their audits.

- Reword paragraph 21 and related paragraph A74 to more clearly explain the actions required of the auditor related to objectives in the individual AU sections.

We provide proposed wording for these inclusions on pages 21, 22, and 39 of the attachment to this letter and have noted other minor proposed wording changes in this attachment.

Comments on Other Matters:

Paragraph A61 indicates that GAAS is relevant to financial statement audit and attestation engagements of governmental entities. We recommend removing the reference to attestation engagements since GAAS apply only to financial statement audits.

We thank you for considering our comments on these important issues.

Sincerely yours,

Jeanette Franzel
for
McCoy Williams
Managing Director
Financial Management and Assurance

Attachment

cc:
Mr. Harold Monk, Chair
Auditing Standards Board

The Honorable Mark W. Olson, Chairman
Public Company Accounting Oversight Board

EXPOSURE DRAFT

PROPOSED PREFACE TO *CODIFICATION OF STATEMENTS ON AUDITING STANDARDS*,

PRINCIPLES GOVERNING AN AUDIT CONDUCTED IN ACCORDANCE WITH GENERALLY ACCEPTED AUDITING STANDARDS

AND

PROPOSED STATEMENT ON AUDITING STANDARDS

OVERALL OBJECTIVES OF THE INDEPENDENT AUDITOR AND THE CONDUCT OF AN AUDIT IN ACCORDANCE WITH GENERALLY ACCEPTED AUDITING STANDARDS

(To supersede Statement on Auditing Standards (SAS) No. 1, *Codification of Auditing Standards and Procedures*, section 110, "Responsibilities and Functions of the Independent Auditor," as amended; section 210, "Training and Proficiency of the Independent Auditor," as amended; section 220, "Independence;" and section 230, "Due Professional Care in the Performance of Work," as amended; SAS No. 95, *Generally Accepted Auditing Standards,* as amended; and SAS No. 102, *Defining Professional Responsibilities in Statements on Auditing Standards* [AICPA, *Professional Standards*, vol. 1])

September 26, 2008

Comments are requested by December 30, 2008.

Prepared by the AICPA Auditing Standards Board for comment from persons interested in auditing and reporting issues.

Comments should be addressed to
Sherry Hazel, Audit and Attest Standards,
AICPA, 1211 Avenue of the Americas, New York, NY 10036-8775
or via the Internet to shazel@aicpa.org.

Copyright © 2008 by
American Institute of Certified Public Accountants, Inc.
New York, NY 10036-8775

Permission is granted to make copies of this work provided that such copies are for personal, intraorganizational, or educational use only and are not sold or disseminated and provided further that each copy bears the following credit line: "Copyright © 2008 by American Institute of Certified Public Accountants, Inc. Used with permission."

CONTENTS

Explanatory Memorandum

Introduction

This memorandum provides background to Proposed Preface to *Codification of Statements on Auditing Standards*, *Principles Governing an Audit Conducted in Accordance With Generally Accepted Auditing Standards*¸ and Proposed Statement on Auditing Standards (SAS) *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*. The proposed SAS would supersede SAS No. 1, *Codification of Auditing Standards and Procedures*, section 110, "Responsibilities and Functions of the Independent Auditor," as amended; section 210, "Training and Proficiency of the Independent Auditor," as amended; section 220, "Independence;" and section 230, "Due Professional Care in the Performance of Work," as amended; SAS No. 95, *Generally Accepted Auditing Standards*, as amended; and SAS No. 102, *Defining Professional Responsibilities in Statements on Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 110, 201, 210, 220, 230, 120, and 150). The accompanying proposed SAS represents the redrafting of the superseded SASs to apply the Auditing Standards Board's (ASB) clarity drafting conventions and to converge with International Standards on Auditing (ISAs), as discussed in the following sections.

Background

Clarity

To address concerns over the clarity, length, and complexity of its standards, the ASB is currently undertaking a significant effort to clarify the SASs. The ASB issued a discussion paper titled *Improving the Clarity of ASB Standards*[1] in March 2007. In response to the feedback received on the discussion paper and subsequent discussions with interested parties, the ASB has established clarity drafting conventions and has undertaken to revise all of its SASs in accordance with those conventions. The proposed preface and SAS have been drafted in accordance with the ASB's clarity drafting conventions, which include the following:

- Establishing objectives for each of the standards
- Including a definitions section, where relevant, in each standard
- Separating requirements from application and other explanatory material

[1] The discussion paper is available online at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Improving+the+Clarity+of+ASB+Standards.htm.

- Numbering application and other explanatory material paragraphs using an *A*-prefix and presenting them in a separate section that follows the requirements section
- Using formatting techniques, such as bulleted lists, to enhance readability
- Including, where appropriate, special considerations relevant to audits of smaller, less complex entities within the text of the standard
- Including, where appropriate, special considerations relevant to audits of governmental entities within the text of the standard[2]

Convergence

Consistent with the ASB's strategy to converge its standards with those of the International Auditing and Assurance Standards Board (IAASB),[3] the proposed SAS has been drafted using ISA 200 (Revised and Redrafted), *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, as a base. Differences in objectives, definitions, or requirements between the proposed SAS and ISA 200 are identified in the exhibit to the exposure draft.

The ASB has made various changes to the language of the ISA to use terms or phrases that are more commonly used in the United States, and to tailor examples and guidance to be more appropriate to the U.S. environment. The ASB believes that such changes will not create differences between the application of ISA 200 and the application of the proposed SAS.

Effective Date

The proposed SAS will be effective for audits of financial statements for periods beginning on or after December 15, 2010. This effective date is provisional but will not be earlier than December 15, 2010.

Changes from Existing Standards

The 10 Standards

The proposed SAS would supersede SAS No. 95, as amended, which contains the general, field work, and reporting standards (the 10 standards). The ASB discussed at great length the function of the 10 standards, and the effect on the 10 standards of

[2] The Clarity Project Explanatory Memorandum, available online at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Improving+the+Clarity+of+ASB+Standards.htm, provides a more detailed discussion of the Auditing Standards Board's (ASB) Clarity Project.

[3] The ASB's convergence paper is available online at www.aicpa.org/download/auditstd/ASB_Convergence_Plan.pdf.

redrafting SAS No. 95, as amended, to apply the clarity drafting conventions and to converge with ISA 200.

Currently, the SASs are codified within the framework of the 10 standards. Auditors are familiar with the 10 standards, which are viewed as the historical basis for generally accepted auditing standards (GAAS). The 10 standards also serve a valuable function in education and litigation support. They are helpful in understanding an audit and in explaining what an audit is to a lay person.

The 10 standards often are described as a summary of the individual SASs. However, the 10 standards are not consistently drafted: the general and field work standards are broad requirements, whereas the reporting standards are very detailed requirements.

The clarity drafting conventions adopted by the ASB include establishing an objective or objectives for each SAS. The proposed SAS establishes the overall objectives of the auditor, which are

a. to 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 prepared, in all material respects, in accordance with an applicable financial reporting framework; and

b. to report on the financial statements, or otherwise as required by the SASs, in accordance with the auditor's findings.

As explained in paragraph A70 of the proposed SAS, each SAS contains an objective, or objectives, that provides a link between the requirements and the overall objectives of the auditor. The SASs taken together provide the standards for the auditor's work in fulfilling the overall objectives of the auditor.

If an auditor fulfills the overall objective of the auditor and meets applicable ethical requirements, such as the AICPA Code of Professional Conduct, the ASB believes that the auditor will have fulfilled the requirements currently stated in the 10 standards. Accordingly, the proposed SAS does not contain 10 unconditional requirements that are the direct equivalent of the 10 standards.

However, the ASB has concluded that the functions of the 10 standards, in setting the structure for the codification of the SASs, in describing what an audit is, and as used in the classroom and the courtroom, are valuable. To preserve those functions of the 10 standards, the ASB has developed the proposed *Principles Governing the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (referred to as the principles). It is proposed that the principles will be placed in a preface to the AU sections in volume 1 of AICPA *Professional Standards*.

The 10 standards are currently stated as unconditional requirements. To have a framework of 10 unconditional requirements precede objectives that are followed by requirements to meet those objectives is inconsistent and not logical. Accordingly, the principles have been drafted in the present tense. They are not requirements and do not carry any authority. Rather, they are the fundamental principles that govern an audit and are supported by the objectives and requirements of the individual SASs.

The principles are organized to provide a structure for the codification of the redrafted SASs, consistent with the current structure. This structure addresses the purpose of an audit (purpose), personal responsibilities of the auditor (responsibilities), auditor actions in performing the audit (performance), and reporting (reporting). It is similar to the structure of the 10 standards (general, fieldwork, and reporting). The headings “General” and “Fieldwork” have been changed to “Responsibilities” and “Performance,” respectively, to better reflect the content. The reporting principles have been drafted at a less detailed level than the current reporting standards, which are at a more detailed level than the current general and fieldwork standards.

Applicable Financial Reporting Frameworks

The proposed SAS introduces the terms *financial reporting framework*, *applicable financial reporting framework*, *fair-presentation framework*, and *regulatory and contractual-based framework*. Examples of *financial reporting frameworks* are accounting principles generally accepted in the United States of America (GAAP), International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB), or comprehensive bases of accounting other than GAAP (OCBOA). The *applicable financial reporting framework* is the financial reporting framework adopted by management in the preparation and presentation of the financial statements. The term *fair presentation framework* is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and

a. 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

b. 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.

The term *regulatory or contractual-based framework* is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in (*a*) or (*b*) of the preceding. This type of framework is referred to in the ISAs as a *compliance framework*; the term was changed for purposes of GAAS to *regulatory or contractual-based framework* to avoid confusion with the term *compliance audit*.

Guide for Respondents

The ASB is seeking comments specifically on changes resulting from applying the clarity drafting conventions and convergence with ISAs, and their effect on the content of the SAS, and on the proposed preface. Respondents are asked to respond in particular to the following questions:

1. Are the objectives to be achieved by the auditor, stated in the proposed SAS, appropriate?
2. Are revisions from the existing standards to converge with ISA 200 appropriate?
3. Are the differences between the proposed SAS and ISA 200 identified in the exhibit, and other language changes, appropriate?
4. Have considerations for audits of smaller, less complex entities and governmental entities been dealt with appropriately?

In addition, the ASB is seeking comments as to whether the discussion of the inherent limitations of an audit in the proposed SAS is balanced and appropriately located within the proposed SAS.

Comments are most helpful when they refer to specific paragraphs, include the reasons for the comments, and, where appropriate, make specific suggestions for any proposed changes to wording. When a respondent agrees with proposals in the exposure draft, it will be helpful for the ASB to be made aware of this view.

Written comments on the exposure draft will become part of the public record of the AICPA and will be available for public inspection at the offices of the AICPA after January 30, 2009, for one year. Responses should be sent to Sherry Hazel, Audit and Attest Standards, AICPA, 1211 Avenue of the Americas, New York, NY 10036-8775 in time to be received by December 30, 2008. Responses may also be sent by e-mail to shazel@aicpa.org.

Supplement to the Exposure Draft

To assist respondents in responding to the request for comment on the proposed SAS, the Audit and Attest Standards staff has prepared supplementary material comprising the following materials:

- *Mapping Document*. A schedule that demonstrates how the extant SASs to be superseded (SAS Nos. 1, 95, and 102) either are reflected in the proposed SAS or are contained in the AICPA Code of Professional Conduct (ET sections in *Professional Standards*); Statement of Quality Control Standards (SQCS) No. 7, *A Firm's System of Quality Control* (AICPA, *Professional Standards*, vol. 2, QC sec. 10); or in other SASs (and in other ISAs to which the other SASs will be converged).
- *Detailed Differences Between International Standard on Auditing (ISA) 200 (Revised and Redrafted),* Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, and*

the Proposed SAS. A paragraph-by-paragraph comparison in a table that contains the following three columns:

1. ISA 200
2. The proposed SAS, marked to show differences in language between the ISA and the proposed SAS (new material is shown in boldface italics; deleted material is shown in strikethrough)
3. Comments and rationale

This staff-prepared supplementary material is for informational purposes only and is not a part of the exposure draft. However, it may be useful to respondents in formulating comments and is available on the AICPA Web site by visiting www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Exposure+Drafts+of+Proposed+Statements/OverallObjectives.htm

Comment Period

The comment period for this exposure draft ends on December 30, 2008.

Auditing Standards Board
(2007–2008)

Harold L. Monk, Jr., *Chair*
Sheila M. Birch
Jacob J. Cohen
Walton T. Conn, Jr.
Anthony J. Costantini
Robert D. Dohrer
Charles E. Frazier
Nicholas J. Mastracchio, Jr.
Jorge Milo
Andrew M. Mintzer
Keith O. Newton
Patricia P. Piteo
Douglas R. Prawitt
Randy C. Roberts
Darrel R. Schubert
Thomas M. Stemlar
Stephanie A. Westington
Arthur M. Winstead, Jr.
Megan F. Zietsman

Overall Objectives Task Force

John Fogarty, *Chair*
Susan S. Jones
Nicholas J. Mastracchio, Jr.
Keith O. Newton
Patricia P. Piteo
Gail Flister Vallieres

AICPA Staff

Charles E. Landes
Vice President
Professional Standards and Services

Ahava Z. Goldman
Technical Manager
Audit and Attest Standards

Proposed Preface to *Codification of Statements on Auditing Standards*, *Principles Governing an Audit Conducted in Accordance With Generally Accepted Auditing Standards*

Purpose of an Audit and Premise Upon Which an Audit is Conducted

1. The purpose of an audit is to enhance the degree of confidence that intended users can place in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

2. An audit in accordance with generally accepted auditing standards is conducted on the premise that management and, where appropriate, those charged with governance have responsibility

a. for the preparation and presentation of the financial statements in accordance with the applicable financial reporting framework; this includes the design, implementation, and maintenance of internal control relevant to the preparation and presentation of financial statements that are free from material misstatement, whether due to fraud or error; and

b. to provide the auditor with

(1) all information, such as records, documentation, and other matters that are relevant to the preparation and presentation of the financial statements;

(2) any additional information that the auditor may request from management and, where appropriate, those charged with governance; and

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

Responsibilities

3. Auditors are responsible for having appropriate competence and capabilities to perform the audit; complying with relevant ethical requirements, including those pertaining to independence and due care; and maintaining professional skepticism and exercising professional judgment, throughout the planning and performance of the audit.

Performance

4. To express an opinion, the auditor obtains reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.

5. To obtain reasonable assurance, which is a high but not absolute level of assurance, the auditor
   - plans the work and properly supervises any assistants.
   - determines appropriate materiality level or levels.
   - identifies and assesses risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's internal control.
   - obtains sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks.
6. The auditor is unable to obtain absolute assurance that the financial statements are free from material misstatement because of inherent limitations, which arise from
   - the nature of financial reporting;
   - the nature of audit procedures; and
   - the need for the audit to be conducted within a reasonable period of time and at a reasonable cost.

Reporting

7. The auditor expresses an opinion in accordance with the auditor's findings, or states that an opinion cannot be expressed, in the form of a written report. The opinion states whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

PROPOSED STATEMENT ON AUDITING STANDARDS

OVERALL OBJECTIVES OF THE INDEPENDENT AUDITOR AND THE CONDUCT OF AN AUDIT IN ACCORDANCE WITH GENERALLY ACCEPTED AUDITING STANDARDS

CONTENTS

Proposed Statement On Auditing Standards *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*

Introduction

Scope of This Statement on Auditing Standards

1. This Statement on Auditing Standards (SAS) establishes the independent auditor's overall responsibilities when conducting an audit of financial statements in accordance with generally accepted auditing standards (GAAS). Specifically, it sets out the overall objectives of the independent auditor, and explains the nature and scope of an audit designed to enable the independent auditor to meet those objectives. It also explains the scope, authority, and structure of GAAS; and includes requirements establishing the general responsibilities of the independent auditor applicable in all audits, including the obligation to comply with GAAS. The independent auditor is referred to as *the auditor* hereafter.

2. GAAS are developed and issued in the form of SASs and are codified into AU sections in volume 1 of AICPA *Professional Standards*. GAAS are written in the context of an audit of financial statements by an auditor. They are to be adapted as necessary in the circumstances when applied to audits of other historical financial information.

An Audit of Financial Statements

3. The purpose of an audit is to enhance the degree of confidence that intended users can place in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general purpose frameworks, that opinion is on whether the financial statements are presented fairly, in all material respects, in accordance with the framework. An audit conducted in accordance with GAAS and relevant ethical requirements enables the auditor to form that opinion. (Ref: par. A1)

4. The financial statements subject to audit are those of the entity, prepared and presented by management of the entity with oversight from those charged with governance. GAAS does not impose responsibilities on management or those charged with governance and does not override laws and regulations that govern their responsibilities. However, an audit in accordance with GAAS is conducted on the premise that management and, where appropriate, those charged with governance have responsibilities that are fundamental to the conduct of the audit. The audit of the financial statements does not relieve management or those charged with governance of those responsibilities. (Ref: par. A2–A13)

5. As the basis for the auditor's opinion, GAAS requires the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a high, but not absolute, level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (that is, the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. However, reasonable assurance is not an absolute level of assurance, because there are inherent limitations of an audit that result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive. (Ref: par. ~~A31–A57~~) A48-A55

6. The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and uncorrected misstatements, if any, on the financial statements.[1] In general, misstatements, including omissions, are considered to be material if, individually or in the aggregate, they could reasonably be expected to influence the ~~economic decisions of users taken~~ judgments of users, including economic decisions, based on the financial statements. Judgments about materiality are made in light of surrounding circumstances, ~~and~~ and necessarily involve both qualitative and quantitative considerations. These judgments are affected by the auditor's perception of the financial information needs of users of the financial statements, and by the size or nature of a misstatement, or a combination of both. The auditor's opinion deals with the financial statements as a whole and therefore the auditor is not responsible for the detection of misstatements that are not material to the financial statements as a whole. (Ref: par. A14)

7. GAAS contains objectives, requirements and application, and other explanatory material that are designed to support the auditor in obtaining reasonable assurance. GAAS requires that the auditor exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit and, among other things

- identify and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's internal control.
- obtain sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks.
- form an opinion on the financial statements based on conclusions drawn from the audit evidence obtained.

8. The form of opinion expressed by the auditor will depend upon the applicable financial reporting framework and any applicable laws or regulations.

9. The auditor may also have certain other communication and reporting responsibilities to users, management, those charged with governance, or parties outside

[1] See AU section 312, *Audit Risk and Materiality* (AICPA, *Professional Standards*, vol. 1).

the entity, in relation to matters arising from the audit. These may be established by GAAS or by applicable laws or regulations.[2]

Effective Date

10. This SAS is effective for audits of financial statements for periods beginning on or after December 15, 2010.[3]

Overall Objectives of the Auditor

The overall objectives of the auditor in conducting an audit of financial statements and the objectives of the auditor in complying with the requirements of this AU Section are

11. ~~In conducting an audit of financial statements, the overall objectives of the auditor are~~

a. to 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 prepared, in all material respects, in accordance with an applicable financial reporting framework;~~ and~~

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

c. to comply with relevant ethical requirements and exercise professional skepticism and professional judgment in planning and performing the audit; to obtain sufficient appropriate audit evidence in relation to audit risk; and to conduct the audit in accordance with GAAS.

12. In all cases when reasonable assurance cannot be obtained and a qualified opinion in the auditor's report is insufficient in the circumstances for purposes of reporting to the intended users of the financial statements, GAAS requires that the auditor disclaim an opinion or withdraw from the engagement, where withdrawal is not prohibited by law or regulation.

Definitions

13. For purposes of GAAS, the following terms have the meanings attributed as follows:

Applicable financial reporting framework. The financial reporting framework adopted by management and, where appropriate, those charged with governance in the preparation and 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. See **financial reporting framework**.

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:

[2] See, for example, AU section 380, *The Auditor's Communication With Those Charged With Governance*, and AU section 316, *Consideration of Fraud in a Financial Statement Audit*, paragraph .82 (AICPA, *Professional Standards*, vol. 1).

[3] This date is provisional, but will not be earlier than December 15, 2010.

(1) 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.

(2) 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 risks 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. Where an AU 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 where 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, accounting principles generally accepted in the United States of America (GAAP), International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB), or comprehensive bases of accounting other than GAAP (OCBOA).

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.

The term *regulatory or contractual-based framework* is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in (1) or (2) of the preceding.

Financial statements. A structured representation of historical financial information, including related notes, intended to communicate an entity's economic resources or 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 in relation to 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 GAAS, exhibits to GAAS, auditing guidance included in AICPA Audit and Accounting Guides, and AICPA Auditing Statements of Position.

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 in accordance with the applicable financial reporting framework. Misstatements can arise from fraud or error.

When the auditor expresses an opinion on whether the financial statements are presented fairly, in all material respects, misstatements also include those adjustments of amounts, classifications, presentations, or disclosures that, in the auditor's judgment, are necessary for the financial statements to be presented fairly, in all material respects.

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; auditing articles in the AICPA *CPA Letter*; continuing professional education programs and other instruction materials, textbooks, guide books, audit programs, and checklists; and other auditing publications from state CPA societies, other organizations, and individuals.

Premise, **relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit is conducted.** Management and, where appropriate, those charged with governance 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 presentation of the financial statements in accordance with the applicable financial reporting framework; this includes the design, implementation, and maintenance of internal control relevant to the preparation and presentation of financial statements that are free from material misstatement, whether due to fraud or error; and

(2) to provide the auditor with

(a) all information, such as records and documentation, and other matters that are relevant to the preparation and presentation of the financial statements;

(b) any additional information that the auditor may request from management and, where appropriate, those charged with governance; and

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

In the case of a fair presentation framework, the responsibility is for the preparation and *fair* presentation of the financial statements in accordance with the financial reporting framework. This applies to all references to *preparation and presentation of the financial statements* in GAAS.

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

Requirements

Ethical Requirements Relating to an Audit of Financial Statements

14. The auditor should comply with relevant ethical requirements, including those pertaining to independence and due care, relating to financial statement audit engagements. (Ref: par. A15–A20)

Professional Skepticism

15. The auditor should plan and perform an audit with professional skepticism, recognizing that circumstances may exist that cause the financial statements to be materially misstated. (Ref: par. A21–A25)

Professional Judgment

16. The auditor should exercise professional judgment in planning and performing an audit of financial statements. (Ref: par. A26–A30)

Sufficient Appropriate Audit Evidence and Audit Risk

17. To obtain reasonable assurance, the auditor should obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion. (Ref: par. A31–A55)

Conduct of an Audit in Accordance With GAAS

Complying With AU Sections Relevant to the Audit

The auditor should obtain a sufficient understanding of all AU sections, including application and other explanatory material, to determine the AU sections that are relevant to the audit.

18. ~~The auditor should comply with all AU sections relevant to the audit.~~ An AU section is relevant to the audit when the AU section is in effect and the circumstances addressed by the AU section exist. (Ref: par. A56–A61)

The auditor should comply with all AU sections relevant to the audit.

19. ~~The auditor should have an understanding of the entire text of an AU section, including its application and other explanatory material, to understand its objectives and to apply its requirements properly.~~ (Ref: par. A62–A69)

20. The auditor should not represent compliance with GAAS in the auditor's report unless the auditor has complied with the requirements of this SAS and all other AU sections relevant to the audit.

Objectives Stated in Individual AU Sections

plan and perform the audit, using the objectives stated in relevant AU sections and considering the interrelationships among GAAS, to

21. To achieve the overall objectives of the auditor, the auditor should ~~use the objectives stated in relevant AU sections in planning and performing the audit considering the interrelationships among GAAS to~~ (Ref: par. A70–A72)

- *a.* determine whether any audit procedures in addition to those required by GAAS are necessary in pursuance of the objectives stated in GAAS; and (Ref: par. A73)
- *b.* evaluate whether sufficient appropriate audit evidence has been obtained. (Ref: par. A74)

Complying With Relevant Requirements

22. Subject to paragraph 24, the auditor should comply with each requirement of an AU section unless, in the circumstances of the audit

- *a.* the entire AU section is not relevant; or
- *b.* the requirement is not relevant because it is conditional and the condition does not exist. (Ref: par. A75–A76)

Defining Professional Responsibilities in GAAS

23. GAAS uses two categories of professional requirements, identified by specific terms, to describe the degree of responsibility it imposes on auditors, as follows:

- *Unconditional requirements.* The auditor must comply with an unconditional requirement in all cases where such requirement is relevant. GAAS uses the word *must* to indicate an unconditional requirement.

- *Presumptively mandatory requirements.* The auditor must comply with a presumptively mandatory requirement in all cases in which such requirement is relevant except in rare circumstances discussed in paragraph 24. GAAS uses the word *should* to indicate a presumptively mandatory requirement. (Ref: par. A77)

24. In rare circumstances, the auditor may judge it necessary to depart from a relevant presumptively mandatory requirement. In such circumstances, the auditor should perform alternative audit procedures to achieve the intent of that requirement. The need for the auditor to depart from a relevant presumptively mandatory requirement is expected to arise only where the requirement is for a specific procedure to be performed and, in the circumstances of the audit, that procedure would be ineffective in achieving the intent of the requirement. (Ref: par. A78)

Interpretive Publications

applicable

25. The auditor should ~~be aware of and~~ consider interpretive publications ~~applicable to his or her audit.~~ (Ref: par. A79) in planning and performing the audit.

Other Auditing Publications

26. If an auditor applies the auditing guidance included in an other auditing publication, the auditor should, using professional judgment, assess the relevance and appropriateness of such guidance to the circumstances of the audit. (Ref: par. A80–A82)

Failure to Achieve an Objective

27. If an objective in a relevant AU section cannot be achieved, the auditor should evaluate whether this prevents the auditor from achieving the overall objectives of the auditor and, thereby requires the auditor, in accordance with GAAS, to modify the auditor's opinion or withdraw from the engagement. Failure to achieve an objective represents a significant finding or issue requiring documentation in accordance with paragraph .04 of AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1). (Ref: par. A83–A84)

Application and Other Explanatory Material

An Audit of Financial Statements

Scope of the Audit (Ref: par. 3)

A1. The auditor's opinion on the financial statements deals with whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. Such an opinion is common to all audits of financial statements. The auditor's opinion therefore does not assure, for example, the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity. In some circumstances, however, applicable laws and regulations may require auditors to provide opinions on other specific matters, such as the effectiveness of internal control. Although GAAS includes requirements and guidance in relation to such matters to the extent that they are relevant to forming an opinion on the financial statements, the auditor would be required to undertake further work if the auditor had additional responsibilities to provide such opinions.

Preparation of the Financial Statements (Ref: par. 4)

A2. An audit in accordance with GAAS is conducted on the premise that management and, where appropriate, those charged with governance have responsibility

a. for the preparation and presentation of the financial statements in accordance with the applicable financial reporting framework; this includes the design, implementation, and maintenance of internal control relevant to the preparation and presentation of financial statements that are free from material misstatement, whether due to fraud or error; and

b. to provide the auditor with

    (1) all information, such as records and documentation, and other matters that are relevant to the preparation and presentation of the financial statements;

    (2) any additional information that the auditor may request from management and, where appropriate, those charged with governance; and

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

A3. As part of their responsibility for the preparation and presentation of the financial statements, management and, where appropriate, those charged with governance are responsible for

- the identification of the applicable financial reporting framework, in the context of any relevant laws or regulations.
- the preparation and presentation of the financial statements in accordance with that framework.
- an adequate description of that framework in the financial statements.

The preparation of the financial statements requires management to exercise judgment in making accounting estimates that are reasonable in the circumstances, as well as to select and apply appropriate accounting policies. These judgments are made in the context of the applicable financial reporting framework.

A4. The auditor may make suggestions about the form or content of the financial statements~~, or draft them, in whole or in part, based on information from management during the performance of the audit~~. However, the auditor's responsibility for the audited financial statements is confined to the expression of the auditor's opinion on them.

A5. The financial statements may be prepared in accordance with a financial reporting framework designed to meet

- the common financial information needs of a wide range of users (that is, *general purpose financial statements*); or
- the financial information needs of specific users (that is, *special purpose financial statements*).

A6. The applicable financial reporting framework often encompasses financial accounting standards established by an authorized or recognized standards setting organization, or legislative or regulatory requirements. In some cases, the financial reporting framework may encompass both financial accounting standards established by an authorized or recognized standards setting organization and legislative or regulatory requirements. Other sources may provide direction on the application of the applicable financial reporting framework. In some cases, the applicable financial reporting framework may encompass such other sources, or may even consist only of such sources. Such other sources may include

- the legal and ethical environment, including statutes, regulations, court decisions, and professional ethical obligations in relation to accounting matters;
- published accounting interpretations of varying authority issued by standards setting, professional, or regulatory organizations;
- published views of varying authority on emerging accounting issues issued by standards setting, professional, or regulatory organizations;
- general and industry practices widely recognized and prevalent; and

- accounting literature.

Where conflicts exist between the financial reporting framework and the sources from which direction on its application may be obtained, or among the sources that encompass the financial reporting framework, the source with the highest authority prevails. See AU section 411, *The Meaning of* Present Fairly in Conformity with Generally Accepted Accounting Principles (AICPA, *Professional Standards*, vol. 1).

A7. The requirements of the applicable financial reporting framework determine the form and content of the financial statements. Although the framework may not specify how to account for or disclose all transactions or events, it ordinarily embodies sufficiently broad principles that can serve as a basis for developing and applying accounting policies that are consistent with the concepts underlying the requirements of the framework.

A8. Some financial reporting frameworks are fair presentation frameworks, whereas others are regulatory or contractual-based frameworks. Financial reporting frameworks that encompass primarily the financial accounting standards established by an organization that is authorized or recognized to promulgate standards to be used by entities for preparing and presenting general purpose financial statements are designed to achieve fair presentation; for example, GAAP or IFRS issued by the IASB.

and the frameworks established by the Federal Accounting Standards Advisory Board (FASAB) for U.S. Federal Government entities and by the Government Accounting Standards Board (GASB) for U.S. state and local government entities.

A9. The requirements of the applicable financial reporting framework also determine what constitutes a complete set of financial statements. In the case of many frameworks, financial statements are intended to provide information about the financial position, financial performance, and cash flows of an entity. For example, a complete set of financial statements might include a balance sheet; an income statement; a statement of changes in equity; a cash flow statement; and related notes. For some other financial reporting frameworks, a single financial statement and the related notes might constitute a complete set of financial statements. Examples of a single financial statement, each of which would include related notes, are the following:

- Balance sheet
- Statement of income or statement of operations
- Statement of retained earnings
- Statement of cash flows
- Statement of assets and liabilities that does not include owner's equity
- Statement of changes in owners' equity
- Statement of revenue and expenses
- Statement of operations by product lines

A10. AU section 623, *Special Reports* (AICPA, *Professional Standards*, vol. 1), addresses engagements where the auditor issues a report in connection with financial statements whose applicable financial reporting framework is not GAAP.

A11. Because of the significance of the premise to the conduct of an audit, the auditor is required to establish an understanding with the client that includes management's

As set forth in Statement of Federal Financial Accounting Concepts (SFFAC) 2, Entity and Display, a complete set of financial statements of the U.S. Federal Government and/or entities thereof normally include the following: management discussion and analysis; balance sheet; statement of net costs; statement of changes in net position; statement of custodial activities, when appropriate; statement of budgetary resources; statement of program performance measures; accompanying footnotes; required supplemental information pertaining to physical, human, and research and development capital and selected claims on future resources, when appropriate; and other supplemental financial and management information, when appropriate.

responsibilities.[4] The auditor is also required to obtain written representations about whether management and, where appropriate, those charged with governance have fulfilled those responsibilities.[5]

Considerations Specific to Audits of Governmental Entities

A12. The mandates for audits of the financial statements of governmental entities may be broader than those of other entities. As a result, the premise, relating to management's responsibilities, on which an audit of the financial statements of a governmental entity is conducted may include additional responsibilities, such as the responsibility for the execution of transactions and events in accordance with legislation or proper authority.

Move paragraphs A48-A56 to follow paragraph A13

A13. In audits of government entities and entities that receive government awards, auditors may have a responsibility under law, regulation, or grant agreement to report to third parties, such as funding agencies or oversight bodies.

As set forth in Statement of Government Accounting Standards Board (GASBS) 34, Basic Financial Statements and Management's Discussion and Analysis--for State and Local Governments, a complete set of financial statements for U.S. state and local governments consist of: (1) management's discussion and analysis; (2) basic financial statements, including government-wide statements of net assets and activities; fund financial statements for major governmental, enterprise and fiduciary funds; and notes to the financial statements; and (3) required supplementary information, such as budgetary comparison schedules.

Materiality (Ref: par. 6)

Considerations Specific to Governmental Entities

In audits of government entities and entities that receive government awards, additional materiality considerations may apply. For example, qualitative considerations are especially important in audits of such entities and may influence auditor conclusions about the materiality of a misstatement. Auditors also may find it appropriate to use lower materiality levels as compared with those used in non-government audits because of the public accountability of government entities, various legal and regulatory requirements, and the visibility and sensitivity of government programs.

A14. For most state or local governments, a governmental entity's applicable financial reporting framework is based on multiple reporting units. That is, a state or local governmental entity's applicable financial reporting framework requires the presentation of financial statements for its governmental activities, its business-type activities, and each of its major governmental and enterprise funds. Consequently, each reporting unit of the governmental entity represents an opinion unit to the auditor. In this context, the auditor is responsible for the detection of misstatements that are material to an opinion unit within a governmental entity, but is not responsible for the detection of misstatements that are not material to an opinion unit.

Financial Statements (Ref: par 13)

Considerations Specific to Governmental Entities

The applicable financial reporting framework for such entities may include statements that are other than historical and/or other than financial, such as statements of social insurance and/or stewardship information.

Ethical Requirements Relating to an Audit of Financial Statements (Ref: par. 14)

A15. The auditor is subject to relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. Ethical requirements consist of the AICPA Code of Professional Conduct together with rules of state boards of accountancy and applicable regulatory agencies that are more restrictive.

A16. The AICPA Code of Professional Conduct establishes the fundamental principles of professional ethics, which include the following:

- Responsibilities
- The public interest
- Integrity
- Objectivity and independence
- Due care

[4] See AU section 311, *Planning and Supervision*, paragraphs .08–.09 (AICPA, *Professional Standards*, vol. 1).
[5] See AU section 333, *Management Representations*, paragraph .06 (AICPA, *Professional Standards*, vol. 1).

- Scope and nature of services

A17. In the case of an audit engagement, it is in the public interest and, therefore, required by the AICPA Code of Professional Conduct, that the auditor be independent of the entity subject to the audit. The concept of independence refers to both independence in fact and independence in appearance. The auditor's independence from the entity safeguards the auditor's ability to form an audit opinion without being affected by influences that might compromise that opinion. Independence enhances the auditor's ability to act with integrity, to be objective, and to maintain an attitude of professional skepticism. Independence implies an impartiality that recognizes an obligation to be fair not only to management and those charged with governance of an entity but also users of the financial statements who may rely upon the independent auditor's report. Guidance on threats to independence is set forth in the AICPA's Conceptual Framework for AICPA Independence Standards.

A18. Due care requires the auditor to discharge professional responsibilities with competence and to have the appropriate capabilities to perform the audit and enable an appropriate auditor's report to be issued.

A19. Statement on Quality Control Standards (SQCS) No. 7, *A Firm's System of Quality Control* (AICPA, *Professional Standards*, vol. 2, QC sec. 10), sets out the responsibilities of the firm for establishing policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements, including those pertaining to independence.[6]

Considerations Specific to Governmental Entities

A20. In audits of government entities and entities that receive government awards, applicable ethical principles and general standards, including standards on auditor independence, professional judgment, competence, and audit quality control and assurance, are set forth in *Government Auditing Standards* in addition to the AICPA Code of Professional Conduct.

Professional Skepticism (Ref: par. 15)

A21. Professional skepticism includes being alert to, for example,

- audit evidence that contradicts other audit evidence obtained.
- information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
- conditions that may indicate possible fraud.
- circumstances that suggest the need for audit procedures in addition to those required by GAAS.

[6] See Statement on Quality Control Standard (SQCS) No. 7, *A Firm's System of Quality Control*, paragraphs 19–26 (AICPA, *Professional Standards*, vol. 2, QC sec. 10).

A22. Maintaining professional skepticism throughout the audit is necessary if the auditor is, for example, to reduce the risks of

- overlooking unusual circumstances.
- over-generalizing when drawing conclusions from audit observations.
- using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

A23. Professional skepticism is necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in light of the circumstances; for example, in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.

A24. The auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary. Nevertheless, the auditor is required to consider the reliability of information to be used as audit evidence.[7] In cases of doubt about the reliability of information or indications of possible fraud (for example, if conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document may have been falsified), GAAS requires that the auditor investigate further and determine what modifications or additions to audit procedures are necessary to resolve the matter.[8]

A25. The auditor neither assumes that management is dishonest nor assumes unquestioned honesty. The auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance. Nevertheless, a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism or allow the auditor to be satisfied with less-than-persuasive audit evidence when obtaining reasonable assurance.

Professional Judgment (Ref: par. 16)

A26. Professional judgment is essential to the proper conduct of an audit. This is because interpretation of relevant ethical requirements and GAAS and the informed decisions required throughout the audit cannot be made without the application of relevant knowledge and experience to the facts and circumstances. Professional judgment is necessary in particular regarding decisions about

- materiality and audit risk.
- the nature, timing, and extent of audit procedures used to meet the requirements of GAAS and gather audit evidence.

---

[7] See AU section 326, *Audit Evidence*, paragraph .09 (AICPA, *Professional Standards*, vol. 1).
[8] See AU section 326 paragraph .11 and AU section 330, *The Confirmation Process*, paragraph .38 (AICPA, *Professional Standards*, vol. 1).

- evaluating whether sufficient appropriate audit evidence has been obtained, and whether more needs to be done to achieve the objectives of GAAS and thereby, the overall objectives of the auditor.
- the evaluation of management's judgments in applying the entity's applicable financial reporting framework.
- the drawing of conclusions based on the audit evidence obtained; for example, assessing the reasonableness of the estimates made by management in preparing the financial statements.

A27. The distinguishing feature of the professional judgment expected of an auditor is that such judgment is exercised based on competencies developed through relevant training, knowledge, and experience.

A28. The exercise of professional judgment in any particular case is based on the facts and circumstances that are known by the auditor. Consultation on difficult or contentious matters during the course of the audit, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm, such as those required by paragraph 72 of SQCS No. 7, assist the auditor in making informed and reasonable judgments.

A29. Professional judgment can be evaluated based on whether the judgment reached reflects a competent application of auditing standards and accounting principles and is appropriate in light of, and consistent with, the facts and circumstances that were known to the auditor up to the date of the auditor's report.

A30. Professional judgment needs to be exercised throughout the audit. It also needs to be appropriately documented. In this regard, the auditor is required to prepare audit documentation sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the significant professional judgments made in reaching conclusions on significant matters arising during the audit.[9] Professional judgment is not to be used as the justification for decisions that are not otherwise supported by the facts and circumstances of the engagement or by sufficient appropriate audit evidence.

~~**Sufficient Appropriate Audit Evidence and Audit Risk** (Ref: par. 17)~~

~~***Sufficiency and Appropriateness of Audit Evidence***~~

Move paragraphs A31-A34 to SAS 106, *Audit Evidence*.

~~**A31.** Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits (provided the auditor has determined whether changes have occurred since the previous audit that may affect its relevance to the current audit[10]) or a firm's quality control procedures for client acceptance and continuance. In addition to other sources inside and outside the entity, the entity's accounting records are an~~

[9] See AU section 339, *Audit Documentation*, paragraph .10 (AICPA, *Professional Standards*, vol. 1).

~~[10] See AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, paragraph .11 (AICPA, *Professional Standards*, vol. 1).~~

~~important source of audit evidence. Also, information that may be used as audit evidence may have been prepared by a specialist employed or engaged by the entity. Audit evidence comprises both information that supports and corroborates management's assertions and any information that contradicts such assertions. In addition, in some cases, the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and, therefore, also constitutes audit evidence. Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence.~~

Move paragraphs A31-A34 to SAS 106, *Audit Evidence*.

~~**A32.** The sufficiency and appropriateness of audit evidence are interrelated. Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality.~~

~~**A33.** Appropriateness 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. The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.~~

~~**A34.** Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion, is a matter of professional judgment. AU section 326, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1), and other relevant AU sections establish additional requirements and provide further guidance applicable throughout the audit regarding the auditor's considerations in obtaining sufficient appropriate audit evidence.~~

~~***Audit Risk***~~

~~**A35.** Audit risk is a function of the risks of material misstatement and detection risk. The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.~~

Move paragraphs A35-A47 to Audit Risk standards, SASs 107-110.

~~**A36.** For purposes of GAAS, audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not. This risk is ordinarily insignificant. Further, *audit risk* is a technical term related to the process of auditing; it does not refer to the auditor's business risks such as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements.~~

~~*Risks of Material Misstatement*~~

~~**A37.** The risks of material misstatement may exist at two levels:~~

- ~~The overall financial statement level~~
- ~~The assertion level for classes of transactions, account balances, and disclosures~~

~~**A38.** Risks of material misstatement at the overall financial statement level refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.~~

~~**A39.** Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk. Auditors use various approaches to accomplish the objective of assessing the risks of material misstatement. For example, the auditor may make use of a model that expresses the general relationship of the components of audit risk in mathematical terms to arrive at an acceptable level of detection risk. Some auditors find such a model to be useful when planning audit procedures.~~

Move paragraphs A35-A47 to Audit Risk standards, SASs 107-110.

~~**A40.** The risks of material misstatement at the assertion level consist of two components: inherent risk and control risk. Inherent risk and control risk are the entity's risks; they exist independently of the audit of the financial statements.~~

~~**A41.** Inherent risk is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, it may be higher for complex calculations or for accounts consisting of amounts derived from accounting estimates that are subject to significant estimation uncertainty. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement. Factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may also influence the inherent risk related to a specific assertion. Such factors may include, for example, a lack of sufficient working capital to continue operations or a declining industry characterized by a large number of business failures.~~

~~**A42.** Control risk is a function of the effectiveness of the design, implementation, and maintenance of internal control by management to address identified risks that threaten the achievement of the entity's objectives relevant to preparation of the entity's financial statements. However, internal control, no matter how well designed and operated, can only reduce, but not eliminate, risks of material misstatement in the financial statements, because of the inherent limitations of internal control. These include, for example, the possibility of human errors or mistakes, or of controls being circumvented by collusion or inappropriate management override. Accordingly, some control risk will always exist. GAAS provides the conditions under which the auditor is required to, or may choose to, test the operating effectiveness of controls in determining the nature, timing, and extent of substantive procedures to be performed.[11]~~

~~**A43.** GAAS does not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the *risks of material misstatement*. However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations.~~

~~[11] See AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, paragraphs .23–.27 (AICPA, *Professional Standards*, vol. 1).~~

~~The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages or in nonquantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.~~

~~**A44.** AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), establishes requirements and provides guidance on identifying and assessing the risks of material misstatement at the financial statement and assertion levels.~~

Move paragraphs A35-A47 to Audit Risk standards, SASs 107-110.

~~*Detection Risk*~~

~~**A45.** For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessed risks of material misstatement at the assertion level. For example, the greater the risks of material misstatement the auditor believes exists, the less the detection risk that can be accepted and, accordingly, the more persuasive the audit evidence required by the auditor.~~

~~**A46.** Detection risk relates to the nature, timing, and extent of the auditor's procedures that are determined by the auditor to reduce audit risk to an acceptably low level. It is therefore a function of the effectiveness of an audit procedure and of its application by the auditor. Matters such as~~

- ~~adequate planning,~~
- ~~proper assignment of personnel to the engagement team,~~
- ~~the application of professional skepticism, and~~
- ~~supervision and review of the audit work performed~~

~~assist to enhance the effectiveness of an audit procedure and of its application and reduce the possibility that an auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results.~~

~~**A47.** AU section 311, *Planning and Supervision*, and AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1), establish requirements and provide guidance on planning an audit of financial statements and the auditor's responses to assessed risks. Detection risk, however, can only be reduced, not eliminated, because of the inherent limitations of an audit. Accordingly, some detection risk will always exist.~~

Inherent Limitations of an Audit (Ref: par. 5)

Move paragraphs A48-A55 to follow paragraph A13

A48. The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive. The principal inherent limitations of an audit arise from

- the nature of financial reporting;

- the nature of audit procedures; and
- the need for the audit to be conducted within a reasonable period of time and at a reasonable cost.

Move paragraphs A48-A55 to follow paragraph A13

The Nature of Financial Reporting

A49. The preparation of financial statements involves judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgments that may be made. Consequently, some financial statement items are subject to an inherent level of variability that cannot be eliminated by the application of additional auditing procedures. For example, this is often the case with respect to certain accounting estimates. Nevertheless, GAAS requires the auditor to give specific consideration to whether accounting estimates are reasonable in the context of the applicable financial reporting framework and to related disclosures, and to the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.[12]

The Nature of Audit Procedures

A50. There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example:

- There is the possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant to the preparation and presentation of the financial statements or that has been requested by the auditor. Accordingly, the auditor cannot be certain of the completeness of information, even though the auditor has performed audit procedures to obtain assurance that all relevant information has been obtained.
- Fraud may involve sophisticated and carefully organized schemes designed to conceal it. Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation that may cause the auditor to believe that audit evidence is valid when it is not. The auditor is neither trained as nor expected to be an expert in the authentication of documents.
- An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

Timeliness of Financial Reporting and the Balance Between Benefit and Cost

A51. The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive. Appropriate planning assists in making

[12] See AU section 328, *Auditing Fair Value Measurements and Disclosures*; AU section 342, *Auditing Accounting Estimates*; and AU section 410, *Adherence to Generally Accepted Accounting Principles* (AICPA, *Professional Standards*, vol. 1).

Move paragraphs A48-A55 to follow paragraph A13

sufficient time and resources available for the conduct of the audit. Notwithstanding this, the relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost. This is recognized in certain financial reporting frameworks (see, for example, the Financial Accounting Standard Board's Statements of Financial Accounting Concepts). Therefore, there is an expectation by users of financial statements that the auditor will form an opinion on the financial statements within a reasonable period of time and at a reasonable cost, recognizing that it is impracticable to address all information that may exist or to pursue every matter exhaustively on the assumption that information is in error or fraudulent until proved otherwise.

A52. Consequently, it is necessary for the auditor to

- plan the audit so that it will be performed in an effective manner;
- direct audit effort to areas most expected to contain risks of material misstatement, whether due to fraud or error, with correspondingly less effort directed at other areas; and
- use testing and other means of examining populations for misstatements.

A53. In light of the approaches described in paragraph A52, GAAS contains requirements for the planning and performance of the audit and requires the auditor, among other things, to

- have a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels by performing risk assessment procedures and related activities;[13] and
- use testing and other means of examining populations in a manner that provides a reasonable basis for the auditor to draw conclusions about the population.[14]

Other Matters That Affect the Inherent Limitations of an Audit

A54. In the case of certain assertions or subject matters, the potential effects of the inherent limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include

- fraud, particularly fraud involving senior management or collusion. See AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), for further discussion.
- the existence and completeness of related party relationships and transactions. See AU section 334, *Related Parties* (AICPA, *Professional Standards*, vol. 1), for further discussion.
- the occurrence of noncompliance with laws and regulations. See AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1), for further discussion.

---

[13] See AU section 314.

[14] See AU section 318; AU section 326; AU section 329, *Analytical Procedures*; and AU section 350, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1).

Move paragraphs A48-A55 to follow paragraph A13

- future events or conditions that may cause an entity to cease to continue as a going concern. See AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1), for further discussion.

Relevant AU sections identify specific audit procedures to assist in lessening the effect of the inherent limitations.

A55. Because of the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with GAAS. Accordingly, the subsequent discovery of a material misstatement of the financial statements resulting from fraud or error does not by itself indicate a failure to conduct an audit in accordance with GAAS. However, the inherent limitations of an audit are not a justification for the auditor to be satisfied with less-than-persuasive audit evidence. Whether the auditor has performed an audit in accordance with GAAS is determined by the audit procedures performed in the circumstances, the sufficiency and appropriateness of the audit evidence obtained as a result thereof, and the suitability of the auditor's report based on an evaluation of that evidence in light of the overall objectives of the auditor.

Conduct of an Audit in Accordance With GAAS

Nature of GAAS (Ref: par. 18)

A56. Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, vol. 2, ET sec. 202), of the AICPA Code of Professional Conduct requires an AICPA member who performs an audit to comply with standards promulgated by the Auditing Standards Board (ASB). The ASB develops and issues standards in the form of SASs through a process that includes deliberation in meetings open to the public, public exposure of proposed SASs, and a formal vote. The SASs are codified in AU sections in volume 1 of AICPA *Professional Standards*.

A57. GAAS provides the standards for the auditor's work in fulfilling the overall objectives of the auditor. GAAS addresses the general responsibilities of the auditor, as well as the auditor's further considerations relevant to the application of those responsibilities to specific topics.

A58. The scope, effective date, and any specific limitation of the applicability of a specific AU section is made clear in the AU section. Unless otherwise stated in the AU section, the auditor is permitted to apply an AU section before the effective date specified therein.

A59. In certain engagements, the auditor also may be required to comply with other auditing requirements in addition to GAAS, such as *Government Auditing Standards* issued by the comptroller general of the United States. GAAS does not override laws and regulations that govern an audit of financial statements. In the event that those laws and regulations differ from GAAS, an audit conducted only in accordance with laws and regulations will not necessarily comply with GAAS.

A60. The auditor may also conduct the audit in accordance with both auditing standards generally accepted in the United States and

- International Standards on Auditing (ISAs), or
- auditing standards of a specific jurisdiction or country.

In such cases, in addition to complying with each of the AU sections relevant to the audit, it may be necessary for the auditor to perform additional audit procedures in order to comply with the relevant standards of that jurisdiction or country.

Considerations Specific to Audits of Governmental Entities

A61. GAAS is relevant to financial statement audit ~~and attestation~~ engagements of governmental entities. The auditor's responsibilities, however, may be affected by the audit mandate, or by obligations on governmental entities arising from legislation, regulation, government policy requirements, or resolutions of the legislature, which may encompass a broader scope than an audit of financial statements in accordance with GAAS. These additional responsibilities are not dealt with in GAAS. Auditors are required to adhere to *Government Auditing Standards* when auditing U.S. government entities, and when required by law, regulation, contract, or grant agreement. The appendix to *Government Auditing Standards* includes a listing of some of the laws, regulations, and guidelines that require use of *Government Auditing Standards*.

Contents of GAAS (Ref: par. 19)

A62. In addition to objectives and requirements, an AU section contains related guidance in the form of application and other explanatory material. It may also contain introductory material that provides context relevant to a proper understanding of the AU section and definitions. The entire text of an AU section, therefore, is relevant to an understanding of the objectives stated in an AU section and the proper application of the requirements of an AU section.

A63. Where necessary, the application and other explanatory material provides further explanation of the requirements of an AU section and guidance for carrying them out. In particular, it may

- explain more precisely what a requirement means or is intended to cover.
- include examples of procedures that may be appropriate in the circumstances.

Although such guidance does not in itself impose a requirement, it is relevant to the proper application of the requirements of an AU section. These procedures or actions require the auditor's attention and understanding; how and whether the auditor carries out such procedures or actions in the engagement depends on the exercise of professional judgment in the circumstances consistent with the objective of the AU section. The words *may*, *might*, and *could* are used to describe these actions and procedures. The application and other explanatory material may also provide background information on matters addressed in an AU section.

A64. Appendixes form part of the application and other explanatory material. The purpose and intended use of an appendix are explained in the body of the related AU section or within the title and introduction of the appendix itself.

A65. Introductory material may include, as needed, such matters as explanation of

- the purpose and scope of the AU section, including how the AU section relates to other AU sections.
- the subject matter of the AU section.
- the respective responsibilities of the auditor and others in relation to the subject matter of the AU section.
- the context in which the AU section is set.

A66. An AU section may include, in a separate section under the heading "Definitions," a description of the meanings attributed to certain terms for purposes of GAAS. These are provided to assist in the consistent application and interpretation of GAAS, and are not intended to override definitions that may be established for other purposes, whether in law, regulation, or otherwise. Unless otherwise indicated, those terms will carry the same meanings throughout GAAS.

A67. When appropriate, additional considerations specific to audits of smaller, less complex entities and governmental entities are included within the application and other explanatory material of an AU section. These additional considerations assist in the application of the requirements of GAAS in the audit of such entities. They do not, however, limit or reduce the responsibility of the auditor to apply and comply with the requirements of GAAS.

Considerations Specific to Smaller, Less Complex Entities

A68. For purposes of specifying additional considerations to audits of smaller, less complex entities, a *smaller, less complex entity* refers to an entity that typically possesses qualitative characteristics such as

a. concentration of ownership and management in a small number of individuals (often a single individual—either a natural person or another enterprise that owns the entity provided the owner exhibits the relevant qualitative characteristics); and

b. one or more of the following:

(1) Straight forward or uncomplicated transactions

(2) Simple record keeping

(3) Few lines of business and few products within business lines

(4) Few internal controls

(5) Few levels of management with responsibility for a broad range of controls

(6) Few personnel, many having a wide range of duties.

These qualitative characteristics are not exhaustive, they are not exclusive to smaller, less complex entities, and smaller, less complex entities do not necessarily display all of these characteristics.

A69. GAAS refers to the proprietor of a smaller entity who is involved in running the entity on a day-to-day basis as the *owner-manager*.

Objectives Stated in Individual AU Sections (Ref: par. 21)

A70. Each AU section contains one or more objectives that provide a link between the requirements and the overall objectives of the auditor. The objectives in individual AU sections serve to focus the auditor on the desired outcome of the AU section, while being specific enough to assist the auditor in

- understanding what needs to be accomplished and, where necessary, the appropriate means of doing so; and
- deciding whether more needs to be done to achieve the objectives in the particular circumstances of the audit.

A71. Objectives are to be understood in the context of the overall objectives of the auditor stated in paragraph 11 of this SAS. As with the overall objectives of the auditor, the ability to achieve an individual objective is equally subject to the inherent limitations of an audit.

A72. In using the objectives, the auditor is required to consider the interrelationships among the AU sections. This is because, as indicated in paragraph A57, the AU sections deal in some cases with general responsibilities and in others with the application of those responsibilities to specific topics. For example, this SAS requires the auditor to adopt an attitude of professional skepticism; this is necessary in all aspects of planning and performing an audit but is not repeated as a requirement of each AU section. At a more detailed level, AU sections 314 and 318 contain, among other things, objectives and requirements that deal with the auditor's responsibilities to identify and assess the risks of material misstatement and to design and perform further audit procedures to respond to those assessed risks, respectively; these objectives and requirements apply throughout the audit. An AU section dealing with specific aspects of the audit (for example, AU section 342, *Auditing Accounting Estimates* [AICPA, *Professional Standards*, vol. 1]), may expand on how the objectives and requirements of AU sections such as AU sections 314 and 318 are to be applied in relation to the subject of that AU section, but AU section 342 does not repeat those objectives and requirements. Thus, in achieving the objective stated in AU section 342, the auditor considers the objectives and requirements of other relevant AU sections.

Use of Objectives to Determine Need for Additional Audit Procedures (Ref: par. 21*a*)

A73. The requirements of GAAS are designed to enable the auditor to achieve the objectives specified in GAAS, and thereby the overall objectives of the auditor. The proper application of the requirements of GAAS by the auditor is therefore expected to provide a sufficient basis for the auditor's achievement of the objectives. However, because the circumstances of audit engagements vary widely and all such circumstances cannot be anticipated in GAAS, the auditor is responsible for determining the audit procedures necessary to fulfill the requirements of GAAS and to achieve the objectives. In the circumstances of an engagement, there may be particular matters that require the auditor to perform audit procedures in addition to those required by GAAS to meet the objectives specified in GAAS.

Use of Objectives to Evaluate Whether Sufficient Appropriate Audit Evidence Has Been Obtained (Ref: par. 21*b*)

A74. The auditor is required to ~~use the objectives~~ to evaluate whether sufficient appropriate audit evidence has been obtained in the context of the overall objectives of the auditor. If, as a result, the auditor concludes that the audit evidence is not sufficient and appropriate, then the auditor may follow one or more of the following approaches to meeting the requirement of paragraph 21*b*:

plan and perform the audit, using the objectives stated in relevant AU sections and considering the interrelationships among GAAS,

- Evaluate whether further relevant audit evidence has been, or will be, obtained as a result of complying with other AU sections
- Extend the work performed in applying one or more requirements
- Perform other procedures judged by the auditor to be necessary in the circumstances

~~Where none of the preceding is expected to be practical or possible in the circumstances, the auditor will not be able to obtain sufficient appropriate audit evidence and~~ is required by GAAS to determine the effect on the auditor's report or on the auditor's ability to complete the engagement.

When the auditor is unable to obtain sufficient appropriate audit evidence, the auditor

Complying with Relevant Requirements

Relevant Requirements (Ref: par. 22)

A75. In some cases, an AU section (and therefore all of its requirements) may not be relevant in the circumstances. For example, if an entity does not have an internal audit function, nothing in AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1), is relevant.

A76. Within a relevant AU section, there may be conditional requirements. Such a requirement is relevant when the circumstances envisioned in the requirement apply and the condition exists. In general, the conditionality of a requirement will either be explicit or implicit, for example:

- The requirement to modify the auditor's opinion if there is a limitation of scope[15] represents an explicit conditional requirement.
- The requirement to communicate significant deficiencies and material weaknesses in internal control identified during the audit to management and those charged

[15] See AU section 508, *Reports on Audited Financial Statements*, paragraph .20 (AICPA, *Professional Standards*, vol. 1).

with governance,[16] which depends on the existence and identification of such deficiencies, represents an implicit conditional requirement.

Presumptively Mandatory Requirements (Ref: par. 23)

A77. If an AU section provides that a procedure or action is one that the auditor *should consider*, consideration of the procedure or action is presumptively required. Whether the auditor performs the procedure or action is based upon the outcome of the auditor's consideration and the auditor's professional judgment.

Departure from a Requirement (Ref: par. 24)

A78. AU section 339 paragraph .22 establishes documentation requirements in those exceptional circumstances where the auditor departs from a relevant requirement. GAAS does not call for compliance with a requirement that is not relevant in the circumstances of the audit.

Interpretive Publications (Ref: par. 25)

A79. Interpretive publications are not auditing standards. Interpretive publications are recommendations on the application of GAAS in specific circumstances, including engagements for entities in specialized industries. An interpretive publication is issued under the authority of the ASB after all ASB members have been provided an opportunity to consider and comment on whether the proposed interpretive publication is consistent with GAAS. Auditing interpretations of GAAS are included in the AU sections in volume 1 of *Professional Standards*. AICPA Audit and Accounting Guides and auditing Statements of Position are listed in AU appendix D.

Other Auditing Publications (Ref: par. 26)

A80. Other auditing publications have no authoritative status; however, they may help the auditor understand and apply GAAS. The auditor is not expected to be aware of the full body of other auditing publications.

A81. Although the auditor determines the relevance of these publications in accordance with paragraph 26, the auditor may presume that other auditing publications published by the AICPA that have been reviewed by the AICPA Audit and Attest Standards staff are appropriate. These other auditing publications are listed in AU appendix F of volume 1 of *Professional Standards*.

A82. In determining whether an other auditing publication that has not been reviewed by the AICPA Audit and Attest Standards staff is appropriate, the auditor may wish to consider the degree to which the publication is recognized as being helpful in understanding and applying GAAS and the degree to which the issuer or author is recognized as an authority in auditing matters.

Failure to Achieve an Objective (Ref: par. 27)

[16] See AU section 325, *Communicating Internal Control Related Matters Identified in an Audit*, paragraph .20 (AICPA, *Professional Standards*, vol. 1).

A83. Whether an objective has been achieved is a matter for the auditor's professional judgment. That judgment takes account of the results of audit procedures performed in complying with the requirements of GAAS, and the auditor's evaluation of whether sufficient appropriate audit evidence has been obtained and whether more needs to be done in the particular circumstances of the audit to achieve the objectives stated in GAAS. Accordingly, circumstances that may give rise to a failure to achieve an objective include those that

- prevent the auditor from complying with the relevant requirements of an AU section.
- result in it not being practicable or possible for the auditor to carry out the additional audit procedures or obtain further audit evidence as determined necessary from the use of the objectives in accordance with paragraph 21; for example, due to a limitation in the available audit evidence.

A84. Audit documentation that meets the requirements of AU section 339 and the specific documentation requirements of other relevant AU sections provides evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor. Although it is unnecessary for the auditor to document separately (as in a checklist, for example) that individual objectives have been achieved, the documentation of a failure to achieve an objective assists the auditor's evaluation of whether such a failure has prevented the auditor from achieving the overall objectives of the auditor.

A85.

Exhibit: Comparison of Requirements of Proposed Statement on Auditing Standards *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* With Requirements of International Standard on Auditing 200 (Revised and Redrafted), *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With International Standards on Auditing*

This analysis was prepared by the Audit and Attest Standards staff to highlight substantive differences between Proposed Statement on Auditing Standards *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, with International Standard on Auditing 200 (Revised and Redrafted), *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With International Standards on Auditing*, and the rationale therefore. This analysis is not authoritative and is prepared for informational purposes only. It has not been acted on or reviewed by the Auditing Standards Board.

The Auditing Standards Board (ASB) has made various changes to the language throughout the proposed Statement on Auditing Standards (SAS) *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* as compared with International Standard on Auditing (ISA) 200 (Revised and Redrafted), *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With International Standards on Auditing*. Such changes have been made to use terms applicable in the United States and to make the SAS easier to read and apply. The ASB believes that such changes will not create differences between the application of ISA 200 and the application of the proposed SAS.

Generally accepted auditing standards (GAAS), as described in paragraph 23 of the proposed SAS, contain two categories of professional requirements: *unconditional* requirements and *presumptively mandatory* requirements. Paragraph 23 of the proposed SAS contains unconditional requirements for the auditor to comply with an unconditional requirement in all cases where such requirement is relevant, and with a presumptively mandatory requirement, in all cases in which such requirement is relevant except in rare circumstances. As described in ISA 200, the ISAs contain only one category of professional requirements, which the auditor is required to comply with in all cases in which such requirement is relevant except in rare circumstances. The ASB retained two classes of professional requirements so as not to create unnecessary differences with the standards issued by the Public Company Auditing Oversight Board, which contain the same two categories of professional requirements as described in the proposed SAS.

Paragraph 24 of the proposed SAS contains an unconditional requirement for the auditor to document in the working papers his or her justification for a departure from a presumptively mandatory requirement and how the alternative procedures performed in the circumstances were sufficient to achieve the intent of the presumptively mandatory requirement. This requirement is equivalent to the requirement in paragraph 12 of ISA 230, *Audit Documentation*. The ASB believes that this requirement is more appropriately placed in this standard. The placement of this requirement does not create differences between the ISAs as a whole and GAAS as a whole.

Paragraphs 25–26 of the proposed SAS contain requirements relating to interpretive publications and other auditing publications. The ISAs do not address interpretive publications or other auditing publications.