

2023

**Wiley**  
**PRACTITIONER'S GUIDE TO**  
**GAAAS**

Covering All SASs, SSAEs, SSARs,  
and Interpretations

Joanne M. Flood

With complete,  
in-depth coverage  
of all the professional  
standards and valuable  
checklists and  
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**GAAS**  
**2023**





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**Joanne M. Flood, MBA, CPA**

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Published by John Wiley & Sons, Inc., Hoboken, New Jersey.

Published simultaneously in Canada.

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***Library of Congress Cataloging-in-Publication Data is Available:***

ISBN 9781394152704 (Paperback)

ISBN 9781394152711 (ePDF)

ISBN 9781394152728 (ePub)

Cover Design and Image: Wiley

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# PREFACE—ORGANIZATION AND KEY CHANGES

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This book translates the official language of Statements on Auditing Standards (SASs), Statements on Standards for Attestation Engagements (SSAEs), Statements on Standards for Accounting and Review Services (SSARSs), and the interpretations of those standards into easy-to-read and understandable advice. We designed it to help CPAs in the application of, and compliance with, authoritative standards.

## RESOURCES

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*Wiley Practitioner's Guide to GAAS 2023* contains robust tools to help practitioners implement the standards. This book follows the sequence of sections of the AICPA Codification of Statements on Auditing Standards, the Codification of Statements on Standards for Attestation Engagements, and the Codification of Statements on Standards for Accounting and Review Services. Sections are divided into the following easy-to-understand parts:

**Scope.** A handy brief identification of the original standard for the section.

**Definitions of Terms.** A list of official definitions that refers readers to one of the appendices to find explanations of terms that are ordinarily scattered throughout the standards.

**Objectives.** An explanation of the reasons for the section.

**Requirements.** Concise listing and descriptions of those things specifically mandated by the section, and helpful techniques for complying with the fundamental requirements of the section.

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

**Illustrations.** Sample reports and checklists.

## RECENT AUDITING STANDARDS

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### *Audit Evidence*—SAS 142

In July 2020, the ASB issued SAS 142, *Audit Evidence*. This SAS supersedes AU-C 500 and amends other sections. The SAS is effective for audits of financial statements for periods ending on or after December 15, 2022, and its changes are included in this volume.

SAS 142 defines what constitutes audit evidence and lays out the attributes of information that auditors should factor into their evaluation of whether to use that information as audit evidence. Having those attributes in GAAS should also help the auditors maintain professional skepticism. Attributes of audit evidence include:

- Accuracy,
- Completeness,
- Authenticity, and
- Susceptibility to bias.

The SAS provides examples of the use of automated tools and techniques and allows their use in both risk assessment and substantive procedures concurrently. SAS 142 also moves the guidance on management's specialists from AU-C 500 to AU-C 501.

***Auditing Accounting Estimates and Related Disclosures—SAS 143***

SAS 143 enables auditors to address appropriately complex scenarios from accounting standards that include estimates and related disclosures and to enhance the auditor’s focus on factors that drive estimation uncertainty and management biases. Particularly important are estimates related to asset impairments during the current environment of economic uncertainty and volatility.

SAS 143 is effective for audits of financial statements for periods ending on or after December 15, 2023, and its changes are referenced in the appropriate chapters.

***Amendments to AU-C Sections 501, 540, and 620 Related to the Use of Specialists and the Use of Pricing Information Obtained From External Information Sources—SAS 144***

In June 2021, the AICPA Auditing Standards Board (ASB) issued Statement on Auditing Standards 144, *Amendments to AU-C Sections 501, 540, and 620 Related to the Use of Specialists and the Use of Pricing Information Obtained From External Information Sources*. SAS 144 amends AU-C 501, *Audit Evidence—Specific Considerations for Selected Items*, AU-C 540, *Auditing Accounting Estimates and Related Disclosures*, and AU-C 620, *Using the Work of an Auditor’s Specialist*.

The AU-C 501 amendments offer guidance on applying AU-C 540 when management has used the work of a specialist in developing accounting estimates. These changes:

- Enhance guidance about evaluating the work of the management’s specialist and
- Eliminate the reference to using the work of an external inventory-taking firm as using the work of a management’s specialist.

The amendments are not expected to change existing practice.

The Standard adds to AU-C 540 a new appendix, “Use of Pricing Information From Third Parties as Audit Evidence.” This appendix provides guidance on using such information as audit evidence for estimates related to the fair value of financial instruments. The appendix is based on Appendix A, “Special Topics,” of PCAOB Auditing Standard 2501, *Auditing Accounting Estimates, Including Fair Value Measurements*, which contains requirements for auditors of issuers.

Amendments to AU-C 620 enhance the guidance related to using the work of an auditor’s specialist.

SAS No. 144 is effective for audits of financial statements for periods ending on or after December 15, 2023. Early implementation is permitted. The changes are referenced in the applicable chapters.

***Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement—SAS 145***

Practice monitoring programs commonly identify deficiencies in auditor risk assessment procedures. In 2020 U.S. peer reviews, the currently effective AU-C 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, was the leading source of matters for further consideration. To address those deficiencies, in October 2021, the ASB issued Statement on Auditing Standards 145, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. SAS No. 145:

- Supersedes SAS No. 122, as amended,
- Supersedes section 315 of the same title, and
- Amends various AU-C sections in AICPA Professional Standards.



SAS 145, for example, enhances:

- Requirements and guidance related to getting an understanding of the entity’s system of internal control and assessing control risk; and
- Guidance that addresses the economic, technological, and regulatory aspects of the markets and environment in which entities and audit firms operate.

SAS 145 includes revised and new requirements and guidance, including:

- A revised definition of significant risk;
- Revised requirements to evaluate the design of certain controls within the control activities component, including general information technology (IT) controls, and to determine whether such controls have been implemented;
- A new requirement to assess separately inherent risk and control risk; a new requirement to assess control risk at the maximum level such that, if the auditor does not plan to test the operating effectiveness of controls, the assessment of the risk of material misstatement is the same as the assessment of inherent risk;
- A new “stand-back” requirement intended to drive an evaluation of the completeness of the auditor’s identification of significant classes of transactions, account balances, and disclosures;
- Revised requirements relating to audit documentation;
- New guidance on scalability; and
- New guidance on maintaining professional skepticism.

SAS 145 is effective for audits of financial statements for periods ending on or after December 15, 2023. Early implementation is permitted. Changes are referenced in the relevant chapters.

***Quality Management for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards—SAS 146***

SAS No. 146, *Quality Management for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*, issued in June 2022, addresses

- Public interest considerations by encouraging proactive management of quality at the engagement level, emphasizing the importance of the exercise of professional skepticism, enhancing the documentation of the auditor’s judgments, and reinforcing the need for robust communications during the audit.
- How the engagement partner leverages the firm’s system and manages quality at the engagement level. The SAS makes clear that the engagement partner has overall responsibility for managing and achieving quality.

SAS No. 146 becomes effective for audits of financial statements for periods beginning on or after December 15, 2025.

***Inquiries of the Predecessor Auditor Regarding Fraud and Noncompliance With Laws and Regulations—SAS 147***

In June 2022, the ASB issued SAS 147, *Inquiries of the Predecessor Auditor Regarding Fraud and Noncompliance With Laws and Regulations*. The SAS clarifies the guidance related to the inquiries of a predecessor auditor about matters that will help the auditor decide whether to take the engagement. After management authorizes the predecessor auditor to respond to inquiries,

the auditor must inquire about identified or suspected fraud and matters involving noncompliance. Once the auditor accepts the engagement, the auditor must document the inquiries and their results.

SAS 147 is effective for audits of financial statements beginning on or after June 30, 2023.

## **ATTESTATION STANDARDS**

### **SSAE 21**

In September 2020, the ASB issued Statement on Standards for Attestation Engagements (SSAE) No. 21, *Direct Examination Engagements*. SSAE No. 21 adds a new AT-C section—206, *Direct Examination Engagements*, to the attestation standards. This new section enables practitioners to perform an examination engagement in which the practitioner gets reasonable assurance by

- Measuring or evaluating underlying subject matter against criteria and
- Expressing an opinion that conveys the results of that measurement or evaluation.

SSAE No. 21 also amends AT-C section 105, *Concepts Common to All Attestation Engagements*, and supersedes AT-C section 205, *Examination Engagements*.

### **Guidance**

New section AT-C 206:

- Enables entities that do not provide an assertion about whether the underlying subject matter is in accordance with the criteria to undergo an examination engagement, thus providing the public with confidence in information about the underlying subject matter. The entity is always required to acknowledge its responsibility for the underlying subject matter.
- Establishes performance requirements for a direct examination based on AT-C section 205, *Assertion-Based Examination Engagements*, in which the practitioner adapts and applies the requirements in AT-C section 205 to a direct examination engagement unless the requirement cannot be applied as written because of the nature of a direct examination engagement. Specified requirements in AT-C section 206 differ from and replace requirements in AT-C section 205.

The changes to AT-C 105 include adding the terms:

- Underlying subject matter—the phenomenon that is measured or evaluated by applying criteria and
- Subject matter information—the outcome of the measurement or evaluation of the underlying subject matter against the criteria

These additions conform with the terminology in ISAE 3000 (Revised), *Assurance Engagements Other than Audits or Reviews of Historical Financial Information*, which provides for direct engagements. Using these terms, rather than the single-term subject matter, clarifies that in an examination engagement a party other than the practitioner is responsible for the underlying subject matter and the practitioner is required to be independent of the underlying subject matter.

SSAE 21 also adds the terms:

- Direct examination engagement and
- Assertion-based examination

**Effective Date**

SSAE No. 21 is effective for reports dated on or after June 15, 2022, therefore, its provisions are included in this volume.

**SSAE 22**

In March 2021, the FASB issued SSAE 22, *Review Engagements*.

- The SSAE makes clear that the objective of a review engagement is to obtain limited assurance about whether any material modification should be made to the subject matter for it to be in accordance with or based on the criteria.
- The SSAE results in more transparent reporting because the practitioners must disclose the procedures they used to obtain financial assurance.
- When the subject matter is materially and pervasively misstated, the new guidance permits practitioners to issue an adverse review conclusion.

SSAE 22 is effective for practitioners' review reports dated on or after June 15, 2022. Early implementation is permitted only if the practitioner also early implements the amendments to AT-C 105 included in SSAE 105.

**ACCOUNTING AND REVIEW STANDARDS*****Quality Management for an Engagement Conducted in Accordance With Statements on Standards for Accounting and Review Services—SSARS 26***

In June 2022, the Accounting and Review Services Committee issued SSARS No. 26, *Quality Management for an Engagement Conducted in Accordance With Statements on Standards for Accounting and Review Services*. The standard amends AR-Cs 60, 70, and 80. The new Statement:

- Enhances concepts related to quality management for SSARS engagements to ensure their consistency with SAS 146. (See above.) This change is effective for SSARS engagements for periods ending on or after December 15, 2025, and changes are referenced in the relevant chapters.
- Includes a revision to AR-C 90 to ensure that the timing of obtaining the engagement letter is consistent with AR-Cs 70, 80, 90, and 120 and with the attestation and auditing guidance. This change is effective upon issuance and is included in the chapter on AR-C 90.

**Practice Alert**

**New opportunities for performing attestation services.** The *Journal of Accountancy* recently published an article by Abraham Akresh, Alan Reinstein, and Thomas Weirich discussing attestation engagement options for clients and flexibility for practitioners based on new SSAEs 19-21. Examples listed include:

- Reporting on environmental, social, and governance practices
- Product performance metrics meeting industry standards
- Electronic transactions, electronic documents, and supporting systems meeting specific industry criteria

For other engagement examples and an in-depth case study, see the article in the July 2022 issue of the *Journal of Accountancy* at <https://www.journalofaccountancy.com/issues/2022/jul/new-possibilities-performing-attestation-services.html#:~:text=Attestation%20services%20share%20common%20attributes,team%20members%2C%20obtaining%20a%20management>.

**PCAOB planned 2022 inspections** While the PCAOB deals with public entities, all auditors can benefit from their inspection plans. In June 2022, the PCAOB issued “Spotlight Staff Overview for Planned 2022 Inspection”:

- Fraud
- IPOs
- Critical audit matters
- Independence
- Technology
- Use of service providers in the confirmation process
- Contingencies
- Allowance for loan losses
- Auditor’s assessment of the risks of material misstatements
- Identification and testing of the design and operation of controls

For other areas and more details, see the article at [https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/documents/2022-inspections-overview-spotlight.pdf?sfvrsn=8d3e48ef\\_2/2022-Inspections-Overview-Spotlight.pdf](https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/documents/2022-inspections-overview-spotlight.pdf?sfvrsn=8d3e48ef_2/2022-Inspections-Overview-Spotlight.pdf).

## **PUBLICATION CURRENCY**

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This publication is current through SAS No. 147, SSARS 26, and SSAE 19.

Joanne M. Flood  
November 2022

## ABOUT THE AUTHOR

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**Joanne M. Flood, MBA, CPA**, is an author and independent consultant on accounting and auditing technical topics and e-learning. She has experience as an auditor in both an international firm and a local firm and worked as a senior manager in the AICPA's Professional Development group. She received her MBA summa cum laude in accounting from Adelphi University and her bachelor's degree in English from Molloy University. Joanne received the New York State Society of Certified Public Accountants Award of Honor for outstanding scholastic achievement at Adelphi University. Joanne also has a certificate in Designing Interactive Multimedia Instruction from Teachers College, Columbia University.

While in public accounting, Joanne worked on major clients in retail, manufacturing, and finance and on small business clients in construction, manufacturing, and professional services. At the AICPA, Joanne developed and wrote e-learning, text, and instructor-led training courses on US and international standards. She also produced training materials in a wide variety of media, including print, video, and audio, and pioneered the AICPA's e-learning product line. Joanne lives on Long Island, New York, with her daughter, Elizabeth. Elizabeth is also Joanne's editorial assistant, providing valuable production and copyediting services. Joanne is the author of the following Wiley publications:

*Financial Disclosure Checklist*

*Wiley GAAP 2023: Interpretation and Application of Generally Accepted Accounting Principles*

*Wiley Practitioner's Guide to GAAS 2023: Covering All SASs, SSAEs, SSARSs, and Interpretations*

*Wiley GAAP: Financial Statement Disclosures Manual (Wiley Regulatory Reporting)*

*Wiley Revenue Recognition*



# 1

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

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### **TECHNICAL ALERT**

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Recently issued SAS 146 affects AU-C 200. The preface to this volume contains an overview of the SAS, and the changes are noted in this chapter.

### **SCOPE**

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AU-C 200 describes:

- The auditor's overall responsibilities when conducting a GAAS audit, including
  - The auditor's overall objectives,
  - The nature and scope of the audit, and
  - The scope, authority, and structure of GAAS.

(AU-C 200.01)

## DEFINITIONS OF TERMS

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**Source: AU-C 200.14.** For definitions related to this standard, see Appendix A, “Definitions of Terms”: Applicable financial reporting framework, Audit evidence, Audit risk, Auditor, Detection risk, Financial reporting framework, Financial statements, Historical financial information, Interpretive publications, Management, Misstatement, Other auditing publications, Premise, relating to the responsibilities of management and, when appropriate, those charged with governance, on which an audit is conducted (the premise), Professional judgment, Professional skepticism, Reasonable assurance, Risk of material misstatement, Those charged with governance.

## OBJECTIVES OF AU-C 200

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

- a. get reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with an applicable financial reporting framework; and*
- b. report on the financial statements, and communicate as required by GAAS, in accordance with the auditor’s findings.*

(AU-C 200.12)

If the auditor cannot get reasonable assurance and a qualified opinion is insufficient, the auditor must either:

- Disclaim an opinion or
- Withdraw from the engagement when possible under applicable law or regulation.

(AU-C 200.13)

## REQUIREMENTS

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### MANAGEMENT’S RESPONSIBILITIES

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

Many times clients do not understand their responsibilities for audited financial statements. The financial statements are *management’s*. They contain management’s representations. The form and content of the financial statements are management’s responsibility, even if the auditor prepared them or took part in their preparation. Management also is responsible for designing, implementing, and maintaining an effective system of internal control. (See Appendix A, definition of premise.)



## AUDITOR'S OBJECTIVES

The purpose of an audit of financial statements is confined to the expression of an opinion on the financial statements being audited. In performing the audit, the auditor is responsible for compliance with GAAS. (AU-C 200.04)

## MATERIALITY

In every audit, the auditor has to get reasonable assurance<sup>1</sup> about whether the financial statements are free of material misstatement, whether due to errors or to fraud. (AU-C 200.06) Materiality is considered when planning and performing the audit. Misstatements are material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements.<sup>2</sup> However, the auditor is not required to get reasonable assurance that misstatements not material to the financial statements taken as a whole, whether caused by fraud or error, are detected. Materiality considers qualitative and quantitative elements and should be viewed in context. (AU-C 200.07)

## ETHICAL REQUIREMENTS

The auditor has a responsibility to consider GAAS in all audits. For more information, see the section “Complying with GAAS” later in this chapter.

To provide reasonable assurance that it is conforming with generally accepted auditing standards in its audit engagements, an accounting firm should establish quality control policies and procedures. These policies and procedures should apply not only to audit engagements but also to attest any accounting and review services for which professional standards have been established. (AU-C 200.A20) The AICPA's Quality Control Standards detail the firm's responsibility for establishing and maintaining a system of quality control for auditors.<sup>3</sup> See QC Section 10, *A Firm's System of Quality Control*, for more information.<sup>4</sup>

The auditor must be independent. If not independent, the auditor cannot issue a report under GAAS. The only exception is if GAAS provides otherwise or law or regulation requires the auditor to accept the engagement and report on the financial statements. (AU-C 200.15) In that situation, AU-C 705, *Modifications to the Opinion in the Independent Auditor's Report*, applies.

To be *independent*, the auditor must be intellectually honest; to be *recognized* as independent, he or she must be free from any obligation to or interest in the client, its management, or its owners. The auditor should be independent in appearance as well as fact. (AU-C 200.A17) For specific guidance, the auditor should look to the AICPA and the state society codes of conduct and, if relevant, the Securities and Exchange Commission (SEC). (AU-C 210.A21)

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<sup>1</sup> See Appendix A, *Definitions of Terms*.

<sup>2</sup> This definition of materiality is aligned with that of the IASB and the IAASB, and the description used by the U.S. judicial system, the PCAOB, the SEC, and the FASB.

<sup>3</sup> Upon implementation of SAS 146, this sentence becomes: *A Firm's System of Quality Management sets out the firm's responsibilities to design, implement, and operate a system of quality management. Such a system gives the firm reasonable assurance that the firm and its personnel fulfill their responsibilities according to professional standard and applicable legal and regulatory requirements and conduct engagements according to those standards and requirements. SQMS 1 details the engagement partner's responsibility for the firm meeting ethical requirements, including independence.*

<sup>4</sup> Upon implementation of SAS 146, this reference becomes *Statement on Quality Management Standards (SQMS) No.1, A Firm's System of Quality Management*.

#### **4 AU-C 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit**

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

1. Independence is an impartiality that recognizes an obligation for fairness.
2. Integrity pertains to being honest and candid, and requires that service and public trust not be subordinated to personal gain.
3. Objectivity is a state of mind that imposes an obligation to be impartial, intellectually honest, and free of conflicts of interest.
4. Due care requires the auditor to discharge professional responsibilities with the competence and diligence necessary to perform the audit and issue an appropriate report and to render services promptly, thoroughly, and carefully, while observing applicable standards. (AU-C 200.A19)

(AU-C 200.A16)

(See the AICPA's Code of Professional Conduct, ET.0.300.)

### **PROFESSIONAL JUDGMENT AND SKEPTICISM**

#### **Professional Judgment**

The auditor must exercise professional judgment in planning and performing an audit of financial statements. (AU-C 200.17-18) The auditor should:

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

Professional judgment is developed through training and experience. It will come into play in all aspects of the audit, particularly when:

- Assigning materiality,
- Assessing audit risk,
- Evaluating the sufficiency of audit evidence,
- Evaluating management's integrity and judgment, and
- Arriving at conclusions.

(AU-C 200.A28)

As seen from the above list, auditors should exercise professional judgment throughout the audit.

#### **Professional Skepticism**

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

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

- Contradictory evidence,
- Indications of fraud,
- Unusual circumstances and those that suggest the need for additional audit procedures,
- Evidence that calls into question the reliability of documents and responses to inquiries,
- The possibility of collusion when performing the audit, and
- How management may override controls in a way that would make the fraud particularly difficult to detect.

(AU-C 200.A22–.A23)

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

Auditor's biases, whether conscious or unconscious, may affect professional skepticism and judgment. Those biases may affect the design and performance of procedures and the evaluation of audit evidence. Here are examples of some biases:

- Availability—events or experiences that come to mind or are readily available
- Confirmation—items that affirm an existing belief rather than contradict an existing belief
- Overconfidence—overestimating one's ability to make accurate risk assessments or other judgments
- Anchoring—using an initial piece of information to assess inadequately subsequent information
- Automation—favoring information generated by automated systems even when there are questions about its reliability or usefulness

(AU-C 500.A27)

### Sufficient Appropriate Audit Evidence and Audit Risk

In order to form an opinion, the auditor must get reasonable assurance. The auditor gets reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level to draw a reasonable conclusion. See Appendix A for the definition of audit evidence. (AU-C 200.19)

## COMPLYING WITH GAAS

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Auditors must comply with and understand relevant AU-C sections. Relevant sections are those that are in effect and address the circumstances of the audit. (AU-C 200.20 and .21) GAAS uses two categories of professional requirements to describe the degree of responsibility the standards impose on auditors.

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

(AU-C 200.25–.26)

The term *should consider* means that the consideration of the procedure or action is presumptively required, whereas carrying out the procedure or action is not.

## 6 AU-C 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit

AU-C Section 200 also clarifies that explanatory material is intended to explain the objective of the professional requirements, rather than impose a professional requirement for the auditor to perform. (AU-C 200.A66)

### GAAS AND THE GAAS HIERARCHY

The auditor is responsible for planning, conducting, and reporting the results of an audit according to GAAS.<sup>5</sup> GAAS provide the standards for the auditors' work in fulfilling their objectives. Each AU-C section contains objectives that provide a link between the requirements and the overall objectives of the auditors. Auditors should have sufficient knowledge of the AU-C sections to determine when they apply, and should be prepared to justify departures from them.

### Interpretive Publications

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

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

(AU-C 200.A86)

Auditors should consider interpretive publications that apply to their audits.

### Other Auditing Publications

Other auditing publications, listed in Appendix C of this book, are not authoritative but may help auditors to understand and apply GAAS. An auditor should evaluate such guidance to determine whether it is both (1) *relevant* for a particular engagement and (2) *appropriate* for the particular situation. When evaluating whether the guidance is appropriate, the auditor should consider whether the publication is recognized as helpful in understanding and applying SASs, and whether the author is recognized as an auditing authority. AICPA auditing publications that have been reviewed by the AICPA Audit and Attest Standards staff are presumed to be appropriate. (AU-C 200.A87–.A89)

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<sup>5</sup> Generally accepted auditing standards are issued in the form of Statements on Auditing Standards and codified into AU-C sections in the AICPA's Professional Standards.

## 2

# AU-C 210 Terms of Engagement

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### TECHNICAL ALERT

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Recently issued SAS 147 affects AU-C 210. The preface to this volume contains an overview of the SAS, and the changes are noted in this chapter.

### SCOPE

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This section states the requirements and provides application guidance on the auditor's responsibilities when agreeing upon terms of engagement with management and those charged with governance. It also establishes the vitally important preconditions for an audit, for which management is responsible. Engagement letters can also be the foundation of a defense in the event of a dispute with the client. AU-C 220, *Quality Control for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards*, addresses those aspects of engagement acceptance that the auditor can control and the auditor's responsibilities regarding ethical requirements concerning acceptance of an engagement. (AU-C 210.01 and .A1)

### DEFINITIONS OF TERMS

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**Source: AU-C 210.04.** For definitions related to this standard, see Appendix A, "Definitions of Terms": Preconditions for an audit, Recurring audit.

## OBJECTIVES OF AU-C 210

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AU-C Section 210.03 states that:

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

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

## FUNDAMENTAL REQUIREMENTS

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### ENGAGEMENT ACCEPTANCE

#### Preconditions

Unless required to do so by law or regulation, an auditor should discuss the situation with management and not accept an engagement when the preconditions (see Appendix A, “Definitions of Terms”) are not met. (AU-C 210.08) To assess whether those preconditions are met, the auditor should:

- a. determine whether the financial reporting framework<sup>1</sup> to be applied in the preparation of the financial statements is acceptable and*
  - b. obtain the agreement of management that it acknowledges and understands its responsibility*
    - i. for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework;*
    - ii. for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; and*
    - iii. to provide the auditor with*
      - 1. access to all information of which management is aware that is relevant to the preparation and fair presentation of the financial statements, such as records, documentation, and other matters;*
      - 2. additional information that the auditor may request from management for the purpose of the audit; and*
      - 3. unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.*
- (AU-C 210.06)

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

In evaluating whether the financial reporting framework is acceptable, the auditor may want to consider:

- The nature of the entity
- The purpose and nature of the financial statements
- Whether the framework is determined by law or regulator (AU-C 210.A4)

Additional information may include other information, financial or nonfinancial, included in the entity's financial report described in AU-C 720. Examples of this other information include reports on operations, financial summaries, selected quarterly data, and more. If the auditor expects to receive such information after the date of the auditor's report, the auditor may consider including in the engagement letter actions the auditor will take if the other information contains an uncorrected material misstatement. (AU-C 210.A17)

### **Limitation of Scope**

If management limits the scope of the auditor's work so that the auditor will have to disclaim an opinion, the auditor should not accept the engagement. The exception to this is when management is required by law or regulation to have an audit and the disclaimer of opinion is acceptable under law or regulation, for example, with audits of employee benefit plans. Then the auditor may accept the engagement, but is not required to do so. (AU-C 210.07 and .A19)

### **Agreement on Terms**

The auditor should establish an understanding in writing with management or those charged with governance<sup>2</sup> about the services to be performed for each audit, review of a public company's financial statements, or agreed-upon procedures for engagement. (AU-C 210.09) The understanding should include:

1. The engagement's objectives and scope
2. Management's responsibilities
3. Auditor's responsibilities
4. The audit's limitations, the inherent limitations of internal control, and the risk that some misstatements may not be detected
5. Financial reporting framework
6. Expected form and content of the report (AU-C 210.10)

In addition, the auditor may want to:

- Elaborate on the scope of the audit by referencing regulations, laws, GAAS, ethical codes, and pronouncements of professional bodies, as applicable.
- The communication of key audit matters.
- Identify any other communications in addition to the auditor's report.
- Discuss audit planning and performance, including composition of the audit team.

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<sup>2</sup> In this chapter, references to management should be read as "management and, when appropriate, those charged with governance," unless the context suggests otherwise. Those charged with governance are those "with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity," including the financial reporting process. (AU-C Glossary of Terms)

- Remind management to provide access to all information relevant to the preparation and fair presentation of the financial statements, including information relevant to disclosures.
  - Remind management about the expectation of written representation, the agreement to make available draft financial statements on a timely basis, including information relevant to the preparation and fair presentation of the financial statements whether obtained from within or outside of the general and subsidiary ledgers.
  - Remind management about the agreement for management to inform the auditor of subsequent events or facts discovered after the date of the financial statements that may affect the financial statements.
  - Detail fees and billing arrangements.
  - Request management to acknowledge receipt of the engagement letter and to agree to the terms by signing the letter.
- (AU-C 210.A24)

GAAS does not require auditors to communicate key audit matters. If, however, the engagement letter indicates that the auditor will do so and later it has decided not to do so, the letter should be modified. The reverse is also true. If, after the engagement letter is signed, management requests that the auditor communicate key audit matters, the auditor should consider issuing a new engagement letter or an addendum to the assigned letter. (AU-C 210.A25)

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

If the auditor fails to establish an understanding, the auditor should decline the engagement. (AU-C 210.08) A sample engagement letter is included at the end of this chapter.

### **Initial Audits, Including Reaudits**

Inquiry of the predecessor auditor is critical because the predecessor may provide information that will assist the successor auditor in deciding whether to accept the engagement. The communication may be written or oral. (AU-C 210.A33) Both the predecessor and successor auditors should treat any information obtained from each other as confidential information. (AU-C 210.A31) The successor auditor should request permission from the prospective client to make an inquiry of the predecessor *prior to final acceptance of the engagement*. However, the successor auditor may make a proposal for an audit engagement before having permission to inquire of the predecessor auditor.

The successor auditor, for both initial and reaudit engagements, should ask the prospective client to authorize the predecessor to respond fully to the successor auditor's inquiries. If a prospective client refuses to permit the predecessor auditor to respond or limits the response, the successor auditor should inquire as to the reasons and consider the implications of that refusal or limitation in deciding whether to accept the engagement. (AU-C 210.11)

An auditor authorized to make inquiries of the predecessor auditor should ask about matters that will help the auditor decide whether to accept the engagement, including

- Identified or suspected fraud by management, employees with significant roles in internal control, and others when the fraud results in a material misstatement.
  - Unless clearly inconsequential, noncompliance, suspected or actual, with laws and regulations that came to the predecessor auditor's attention.
- (AU-C 210-12)<sup>3</sup>

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<sup>3</sup> This paragraph is effective upon implementation of SAS 147.



Before responding to inquiries, the predecessor auditor may want to obtain legal advice regarding professional or legal requirements or unusual circumstances that limit ability to respond. (AU-C 210.A33)<sup>4</sup>

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

1. Information about management's integrity
  2. Disagreements with management about accounting principles, auditing procedures, or other significant matters
  3. Communications to management and those charged with governance and responsibility regarding significant deficiencies and material weaknesses in internal control
  4. The predecessor auditor's understanding of the reasons for the change of auditors
  5. The predecessor auditor's understanding of the nature of the entity's relationships and transactions with related parties and significant unusual transactions
- (AU-C 210.A32)

The predecessor auditor should respond promptly, fully, and factually based on known facts. However, if the predecessor decides, because of unusual circumstances such as impending, threatened, or potential litigation; disciplinary proceedings; or other unusual circumstances, not to respond fully, he or she should indicate that the response is limited. These circumstances are expected to be rare. (AU-C 210.13) Also, if more than one auditor is considering accepting the audit, the predecessor auditor does not have to respond to inquiries until the entity selects an auditor. (AU-C 210.A34) Any information exchanged between the predecessor and successor auditors should be considered confidential. (AU-C 210.A30)

If the successor auditor receives a limited response, that auditor should consider the implications of the limited response in deciding whether to accept the engagement. (AU-C 210.14)

For governmental entities, if a law or regulation requiring an audit identifies the entities to be audited, the auditor may need to get authorization from the individuals contracting for or requesting the audit and those legislative committees that have ongoing oversight responsibilities for the entity. (AU-C 210.A36)<sup>5</sup>

## **Documentation**

Once the auditor accepts an engagement, the auditor should document the predecessor auditor inquiries and the results of the inquiries. (AU-C 210-15)<sup>6</sup>

## **Recurring Audits**

For a recurring audit, the auditor should evaluate whether the terms of the engagement need to be changed. The auditor should also remind the client about the existing terms of engagement. (AU-C 210.16)

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<sup>4</sup> *Ibid.*

<sup>5</sup> *Ibid.*

<sup>6</sup> *Ibid.*

Certain factors may warrant a change in the terms of engagement for a recurring engagement. For example, any indication that management misunderstands the objective and scope of the audit and changes in:

- Revised or special terms of the audit engagement
  - Senior management or ownership,
  - Legal or regulatory requirements,
  - The nature or size of the entity, or
  - The financial reporting framework or other reporting requirements.
- (AU-C 210.A37)

### **Change in Terms**

If the client requests a change in the terms, the auditor must ensure that there is a reasonable justification for the change. So, too, if prior to completion of an audit, the client requests a change to an engagement with a lower level of assurance, the auditor must be satisfied that a reasonable justification for doing so exists. (AU-C 210.17 and .18)

If the terms are changed, the auditor and management should document in writing the mutually agreed-upon change. (AU-C 210.19) If, however, the auditor concludes there is no reasonable justification for a change in terms, and management does not allow the auditor to continue the original audit, the auditor must take these three steps:

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

(AU-C 210.20)

### **Report Layout Required by Law or Regulation**

If the report prescribed by law or regulation does not align with GAAS in significant ways, the auditor must decide whether the format would mislead the users and if the report could be reworded to align with GAAS or alternatively whether the auditor could attach a separate report. If none of those remedies are available, the auditor should decline the engagement unless required by law or regulation not to perform the engagement. (AU-C 210.21)