ACCOUNTING AND AUDIT MANUAL
AAM Section 1000

Introduction

The AICPA Audit and Accounting Manual has not been approved, disapproved, or otherwise acted upon by any senior technical committees of the AICPA or FASB and has no official or authoritative status.

AAM Section 1100

Introduction

.01

The Audit and Accounting Manual has been prepared by the staff of the AICPA and issued as a nonauthoritative practice aid. The materials included in it are intended primarily as a reference source for conducting audit engagements. The objective is to provide practitioners with the tools needed to help plan, perform, and report on their engagements. The manual is not intended to serve as a complete or comprehensive quality control system.

.02

The manual, where practicable, offers choices and alternatives rather than particular positions. The use of this or any other practice aid requires the exercise of individual professional judgment. The manual is not a substitute for the authoritative technical literature, and users are urged to refer directly to applicable authoritative pronouncements for the text of technical standards.

.03

This manual is intended to be used in connection with engagements of nonpublic entities and is not intended to be used in connection with audits of public entities that are required to be audited under standards set by the PCAOB.

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The authors hope that the manual will be helpful to practitioners in the conduct of their audit and accounting practice. However, no generalized material, such as that included in this manual, can be a substitute for the development and implementation by a firm of a system of quality control
that is appropriately comprehensive and suitably designed in relation to the firm's organizational structure, its policies, and the nature of its practice.

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The following table provides a summary of abbreviations used throughout the manual.

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<td>AT = Reference to section number in AICPA Professional Standards for Statements on Standards for Attestation Engagements</td>
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<td>AU-C = Reference to section number in AICPA Professional Standards for Clarified Statements on Auditing Standards</td>
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<td>AUD = Reference to section number in the Auditing and Attestation Statements of Position in AICPA Professional Standards</td>
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<td>ET = Reference to section number in AICPA Professional Standards for the Code of Professional Conduct, Interpretations of Rules of Conduct, and Ethics Rulings</td>
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<td>FASB ASC = Reference to the FASB Accounting Standards Codification®</td>
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<td>GAAP = Generally accepted accounting principles</td>
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<td>QC = Reference to section number in AICPA Professional Standards for Statements on Quality Control Standards</td>
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<td>SAS = AICPA Statement on Auditing Standards</td>
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Guidance Considered in This Edition

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This edition of the manual has been modified by the AICPA staff to include certain changes necessary due to the issuance of authoritative guidance since the last edition of the manual, and other revisions as deemed appropriate. Authoritative guidance issued through June 1, 2015, has been considered in the development of this edition of the manual. However, this manual does not include all audit, accounting, reporting,
and other requirements applicable to an entity or a particular engagement. This manual is intended to be used in conjunction with all applicable sources of authoritative guidance.

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Authoritative guidance that is issued and effective for entities with fiscal years ending on or before June 1, 2015, is incorporated directly in the text of this manual. The presentation of authoritative guidance issued but not yet effective as of June 1, 2015, for entities with fiscal years ending after that same date is being presented as a guidance update, which is a shaded area that contains information on the new guidance. The distinct presentation of this content is intended to aid the reader in differentiating content that may not be effective for the reader’s purposes.

.08

This manual includes relevant guidance issued up to and including the following:

- SAS No. 129, Amendment to Statement on Auditing Standards No. 122 Section 920, Letters for Underwriters and Certain Other Requesting Parties, as Amended (AICPA, Professional Standards, AU-C sec. 920)
- Interpretation No. 4, “Consideration of Financial Statements Effects,” of AU-C section 570, The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern (AICPA, Professional Standards, AU sec. 9570 par. .09–.10)
- QC section 10, A Firm’s System of Quality Control (AICPA, Professional Standards)

Users of this manual should consider guidance issued subsequent to those items in the preceding list to determine its effect on entities covered by this manual. In determining the applicability of recently issued guidance, its effective date should also be considered.

**Defining Professional Responsibilities in AICPA Professional Standards**

.09

AICPA professional standards applicable to audit engagements use the following two categories of professional requirements, identified by specific terms, to describe the degree of responsibility they impose on auditors:

- *Unconditional requirements*. The auditor must comply with an unconditional requirement in all cases in which such requirement is relevant. Generally accepted auditing standards (GAAS) as issued by the Auditing Standards Board (ASB) use 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 a requirement is relevant except in rare circumstances. GAAS use the word *should* to indicate a presumptively mandatory requirement.

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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 when the requirement is for a specific procedure to be performed and, in the specific circumstances of the audit, that procedure would be ineffective in achieving the intent of the requirement.

.11

Prior to SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification* (AICPA, *Professional Standards*), the terms *is required to* or *requires* were used to express an unconditional requirement in GAAS (equivalent to *must*). With the issuance of SAS No. 122, the terms *is required to* or *requires* do not convey a requirement or the degree of responsibility it imposes on auditors. Instead those terms are used to express that a requirement exists. The terms are typically used in the clarified auditing standards to indicate that a requirement exists elsewhere in GAAS.

.12

AICPA *Professional Standards* applicable to attest engagements use the following two categories of professional requirements, identified by specific terms, to describe the degree of responsibility they impose on an auditor/accountant/practitioner [*as appropriate*]:

• *Unconditional requirements*. The auditor is required to comply with an unconditional requirement in all cases in which the circumstances exist to which the requirement applies. The terms *must* and *is required* are used to indicate an unconditional requirement.

• *Presumptively mandatory requirements*. The auditor/accountant/practitioner [*as appropriate*] must comply with a presumptively mandatory requirement in all cases in which the circumstances exist to which the requirement applies; however, in rare circumstances the auditor/accountant/practitioner may depart from the requirement provided that the auditor/accountant/practitioner documents his or her justification for the departure and how the alternative procedures performed in the circumstances were sufficient to achieve the objectives of the requirement. The word *should* is used to indicate a presumptively mandatory requirement.

.13

It is important to note that upon the effective date of the clarified auditing standards the terms describing professional requirements for audit engagements is revised, and are therefore different than those used for attest engagements. See the preceding section for information on defining
References to Professional Standards

In citing GAAS and their related interpretations, references use section numbers within the codification of currently effective SASs and not the original statement number, as appropriate. Similarly, when citing attestation standards, and their related interpretations, references use section numbers within the codification of currently effective SSAEs and not the original statement number, as appropriate.

AICPA.org Website

The AICPA encourages you to visit the website at www.aicpa.org and the Financial Reporting Center at www.aicpa.org/FRC. The Financial Reporting Center supports members in the execution of high-quality financial reporting. Whether you are a financial statement preparer or a member in public practice, this center provides exclusive member-only resources for the entire financial reporting process, and provides timely and relevant news, guidance and examples supporting the financial reporting process, including accounting, preparing financial statements and performing compilation, review, audit, attest, or assurance and advisory engagements. Certain content on the AICPA’s websites referenced in this guide may be restricted to AICPA members only.

Select Recent Developments Significant to This Manual

ASB's Clarity Project

To address concerns over the clarity, length, and complexity of its standards, the ASB redrafted standards for clarity and also converged the standards with the International Standards on Auditing, issued by the International Auditing and Assurance Standards Board. As part of redrafting the standards, they now specify more clearly the objectives of the auditor and the requirements with which the auditor has to comply when conducting an audit in accordance with GAAS. The clarified auditing standards are now fully effective.

As part of the clarity project, the “AU-C" identifier was established to avoid confusion with references to existing AU sections. The "AU-C"
identifier had been scheduled to revert back to the "AU" identifier at the end of 2013, by which time the previous AU sections would be superseded for all engagements. However, in response to user requests, the “AU-C” identifier will be retained indefinitely. The superseded AU sections were removed from Professional Standards at the end of 2013, as scheduled.

18

The ASB has completed the Clarity Project with the issuance of SAS No. 128, *Using the Work of Internal Auditors* (AICPA, *Professional Standards*, AU-C sec. 610), in February 2014. This guidance is effective for audits of financial statements for periods ending on or after December 15, 2014.

### AICPA’s Ethics Codification Project

19

The AICPA’s Professional Ethics Executive Committee (PEEC) restructured and codified the AICPA Code of Professional Conduct (code) so that members and other users of the code can apply the rules and reach appropriate conclusions more easily and intuitively. This is referred to as the AICPA Ethics Codification Project.

20

Although PEEC believes it was able to maintain the substance of the existing AICPA ethics standards through this process and limited substantive changes to certain specific areas that were in need of revision, the numeric citations and titles of interpretations have all changed. In addition, the ethics rulings are no longer in a question and answer format but rather, have been drafted as interpretations, incorporated into interpretations as examples, or deleted where deemed appropriate. For example

- **Rule 101, Independence** [ET sec. 101 par. .01], is referred to as the “Independence Rule” [ET sec. 1.200.001] in the revised code.

- the content from the ethics ruling titled “Financial Services Company Client has Custody of a Member’s Assets” [ET sec. 191 par. .081–.082] is incorporated into the “Brokerage and Other Accounts” interpretation [ET sec. 1.255.020] found under the subtopic “Depository, Brokerage, and Other Accounts” [ET sec. 1.255] of the “Independence” topic [ET sec. 1.200].

21

The revised code was effective December 15, 2014, and is available at [http://pub.aicpa.org/codeofconduct](http://pub.aicpa.org/codeofconduct). References to the code have been updated in this manual. To assist users in locating the revised code content from the prior code, PEEC created a mapping document. The mapping document is available in appendix D in the revised code.
See the preceding section titled "Guidance Considered in This Edition" for more information related to the guidance issued as of the date of this manual.

This manual is expected to be updated periodically. Changes will likely arise from three main sources:

a. Comments and suggestions from practitioners. Because this manual is a product of AICPA staff and not of a committee of practitioners, it is particularly important that practitioners advise the staff on any suggestions for material that could be improved or added.

b. Issuance of authoritative guidance.

c. Other additions to or deletions from the manual as a result of continued staff study.

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AICPA TECHNICAL HOTLINE

The AICPA Technical Hotline answers members’ inquiries about accounting, auditing, attestation, compilation, and review services.

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877.242.7212

This service is free to AICPA members.
AAM Section 2000

How to Use the Audit and Accounting Manual

The AICPA Audit and Accounting Manual has not been approved, disapproved, or otherwise acted upon by any senior technical committees of the AICPA or FASB and has no official or authoritative status.
AAM Section 2100

How to Use the Audit and Accounting Manual

Overview

.01

The Audit and Accounting Manual is designed to provide practitioners with the tools needed to help plan, perform, and report on audit engagements. This manual is not intended to serve as a complete or comprehensive quality control system, and it is not intended to be used in connection with the audits of entities that are required to be audited under standards set by the PCAOB. This manual comprises the following sections.

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Independence

.02

The auditor must be independent of the entity when performing an engagement in accordance with generally accepted auditing standards (GAAS) unless (a) GAAS provides otherwise or (b) the auditor is required by law or regulation to accept the engagement and report on the financial
statements. When the auditor is not independent and neither (a) nor (b) are applicable, the auditor is precluded from issuing a report under GAAS.

**Ethical Requirements Relating to an Audit of Financial Statements**

.03

The auditor should comply with relevant ethical requirements relating to financial statement audit engagements.

.04

The auditor is subject to relevant ethical requirements 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.

.05

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
- Scope and nature of services

.06

In the case of an audit engagement, it is in the public interest and, therefore, required by GAAS, 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 “Conceptual Framework for Independence” (AICPA, Professional Standards, ET sec 1.210.010).

.07

When the auditor is not independent but is required by law or regulation to report on the financial statements, AU-C section 705, Modifications to the Opinion in the Independent Auditor’s Report (AICPA, Professional Standards), applies.

.08

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.

.09

Paragraphs .21–.26 of QC section 10, A Firm’s System of Quality Control (AICPA, Professional Standards), set out the firm’s responsibilities to establish and maintain its system of quality control for audit engagements and to establish 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. Paragraphs .11–.13 of AU-C section 220, Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards (AICPA, Professional Standards), addresses the engagement partner’s responsibilities regarding relevant ethical requirements. These include remaining alert for evidence of non-compliance with relevant ethical requirements by members of the engagement team, determining, in consultation with others in the firm as appropriate, the appropriate action if matters come to the engagement partner’s attention, through the firm’s system of quality control or otherwise, that indicate that members of the engagement team have not complied with relevant ethical requirements, and forming a conclusion on compliance with independence requirements that apply to the audit engagement. AU-C section 220 recognizes that the engagement team is entitled to rely on a firm’s system of quality control in meeting its responsibilities with respect to quality control procedures applicable to the individual audit engagement, unless the engagement partner determines that it is inappropriate to do so based on information provided by the firm or other parties.

.10

This manual will assist the auditor in performing an audit in accordance with GAAS in the following ways:

a. Section 3000, Engagement Planning and Administration, provides guidance in the planning stage. Included in this section are various formats of audit assignment controls and engagement letters.
b. Section 4000, Internal Control, conforms to Internal Control—Integrated Framework, published by the Committee of Sponsoring Organizations of the Treadway Commission, and AU-C section 315, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement (AICPA, Professional Standards). This section provides guidance on evaluating internal control by utilizing checklists, questionnaires, and other generalized aids.

c. Section 5000, Designing and Performing Further Audit Procedures, explains how the auditor should design and perform tests of controls, substantive procedures, or both, that are responsive to the assessed risks of material misstatement.

d. Section 6000, Audit Documentation, provides the auditor with a general discussion of the purpose of audit documentation.

e. Section 7000, Correspondence, External Confirmations, and Written Representations, provides the auditor with numerous examples of confirmations, illustrative inquiries to legal counsel, representation letters, communications with audit committees, and a reliance letter.

f. Section 9000, Auditors' Reports, addresses the format of the accountant's report and provides example auditor's reports.

g. Section 10,000, Quality Control, includes sample forms that can be used by a firm to document its adherence to the AICPA requirement for a system of quality control for a CPA firm.

Alerts

.11

Section 8000, Alerts, is intended to provide practitioners with an overview of recent economic, professional, and regulatory developments that may affect their engagements.
AAM Section 3000

Engagement Planning and Administration

Sections 3160 and 3165 include illustrative audit assignment control forms and engagement letters that can be used by an auditor in the planning phase of an audit engagement.

Various formats of audit assignment controls and engagement letters are in use; nevertheless, inclusion of the formats in this section in no way means that they are preferable. Refer directly to authoritative pronouncements when appropriate.

Illustrative formats of audit assignment controls and engagement letters are often helpful in developing a consistent style within a firm. However, no set of illustrative formats can cover all the situations that are likely to be encountered in practice because the circumstances of engagements vary widely.

Readers should consider other sources of illustrative presentations, such as those in authoritative pronouncements and AICPA Audit and Accounting Guides.

References to Professional Standards. In citing generally accepted auditing standards and their related interpretations, references use section numbers within the codification of currently effective Statements on Auditing Standards and not the original statement number, as appropriate.
AAM Section 3100

Understanding the Assignment

This section contains the following references from AICPA Professional Standards:

- AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*
- AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*
- AU-C section 230, *Audit Documentation*
- AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*
- AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*
- AU-C section 300, *Planning an Audit*
- AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
- AU-C section 500, *Audit Evidence*
- AU-C section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*
- AU-C section 550, *Related Parties*
- AU-C section 570, *The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern*
- AU-C section 610A, *The Auditor’s Consideration of the Internal Audit Function in an Audit of Financial Statements*
- The “Compliance With Standards Rule” (ET sec. 1.310.001)
• QC section 10, A Firm’s System of Quality Control

Introduction

.01

To obtain an understanding of the engagement, the auditor may meet with the client to (a) understand the objective, scope, and timing of the engagement; (b) understand if reports on compliance, internal control, or segments of the entity are required; (c) understand the client's expectations, both stated and implied; and (d) review the expectations of both the owners and managers.

.02

To obtain an adequate understanding of any audit, it is important for the auditor to understand accounting principles generally accepted in the United States of America (GAAP), or other applicable framework, which includes Emerging Issues Task Force (EITF) consensuses. AU-C section 200 requires the auditor to understand his or her overall responsibilities when conducting an audit of financial statements in accordance with generally accepted auditing standards (GAAS), which are promulgated by the AICPA and with which the auditor is required to comply. GAAS are developed and issued by the Auditing Standards Board (ASB) in the form of Statements on Auditing Standards (SASs) through a due process that includes deliberation in meetings open to the public, public exposure of proposed SASs, and a formal vote. When issued, SASs are codified into AU-C sections. 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.

.03

GAAS do not address the responsibilities of the auditor that may exist in legislation, regulation, or otherwise, in connection with, for example, the offering of securities to the public. Such responsibilities may differ from those established in GAAS. Accordingly, although the auditor may find aspects of GAAS helpful in such circumstances, it is the responsibility of the auditor to ensure compliance with all relevant legal, regulatory, or professional obligations.

.04

AU-C section 200 establishes requirements and provides guidance regarding the independent auditor’s overall responsibilities when conducting an audit of financial statements in accordance with GAAS. Specifically, AU-C section 200 establishes the overall objectives of the independent auditor (the auditor) and explains the nature and scope of an audit designed to enable the auditor to meet those objectives. It also explains the scope, authority, and structure of GAAS and includes requirements establishing the general responsibilities of the auditor applicable in all audits, including the obligation to comply with GAAS.
Association With Financial Statements

.05

An auditor is associated with financial information when the auditor has applied procedures sufficient to permit the auditor to report in accordance with GAAS. Statements on Standards for Accounting and Review Services address the accountant’s considerations when the accountant prepares and presents financial statements to the entity or to third parties.

An Audit of Financial Statements

.06

The purpose of an audit is to provide financial statement users with an opinion by the auditor on whether the financial statements are presented fairly, in all material respects, in accordance with an applicable financial reporting framework, which enhances the degree of confidence that intended users can place in the financial statements. An audit conducted in accordance with GAAS and relevant ethical requirements enables the auditor to form that opinion.

.07

The financial statements subject to audit are those of the entity, as prepared and presented by management of the entity with oversight from those charged with governance. GAAS do not impose responsibilities on management or those charged with governance and do not override laws and regulations that govern their responsibilities. However, an audit in accordance with GAAS is conducted on the premise that management and, when appropriate, those charged with governance have acknowledged certain 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 their responsibilities.

.08

As the basis for the auditor’s opinion, GAAS require 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. 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.
The concept of materiality is applied by the auditor when both 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. 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 that are taken based on the financial statements. Judgments about materiality are made in light of surrounding circumstances, and 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 both. The auditor’s opinion addresses the financial statements as a whole. Therefore, the auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by fraud or error, that are not material to the financial statements as a whole, are detected.

GAAS contain objectives, requirements, and application and other explanatory material that are designed to support the auditor in obtaining reasonable assurance. GAAS require 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, or determine that an opinion cannot be formed, based on an evaluation of the audit evidence obtained.

The form of opinion expressed by the auditor will depend upon the applicable financial reporting framework and any applicable law or regulation.

The auditor also may have certain other communication and reporting responsibilities to users, management, those charged with governance, or parties outside the entity, regarding matters arising from the audit. These responsibilities may be established by GAAS or by applicable law or regulation.
Financial Accounting Standards Board Accounting Standards Codification

Overview

FASB Accounting Standards Codification (ASC) is a major restructuring of accounting and reporting standards designed to simplify user access to all authoritative GAAP by topically organizing the authoritative literature. FASB ASC disassembled and reassembled thousands of nongovernmental accounting pronouncements (including those of FASB, the EITF, and the AICPA) to organize them under approximately 90 topics.

FASB ASC also includes relevant portions of authoritative content issued by the SEC, as well as selected SEC staff interpretations and administrative guidance issued by the SEC; however, FASB ASC is not the official source of SEC guidance and does not contain the entire population of SEC rules, regulations, interpretive releases, and SEC staff guidance. Moreover, FASB ASC does not include governmental accounting standards.

FASB published a notice to constituents that explains the scope, structure, and usage of consistent terminology of FASB ASC. Constituents are encouraged to read this notice to constituents because it answers many common questions about FASB ASC. FASB ASC, and its related notice to constituents, can be accessed at http://asc.fasb.org/home and are also offered by certain third party licensees, including the AICPA. FASB ASC is offered by FASB at no charge in a Basic View and for an annual fee in a Professional View.

Issuance of Amendments to FASB ASC

Amendments to FASB ASC are now issued through Accounting Standards Updates (ASUs) and serve only to update FASB ASC. FASB does not consider the ASUs authoritative in their own right; such amendments become authoritative when they are incorporated into FASB ASC.

The ASUs issued are in the form of ASU No. 20YY-XX, in which "YY" is the last two digits of the year and "XX" is the sequential number for
each update. For example, ASU No. 2012-01 is the first update in the calendar year 2012. The ASUs include the amendments to the codification and an appendix of FASB ASC update instructions. ASUs also provide background information about the amendments and explain the basis for the board’s decisions.

.18

Amendments to FASB ASC issued in the form of ASUs (or other authoritative accounting guidance issued prior to the release date of FASB ASC) that are not fully effective, or became effective within that last six months, for all entities or transactions within its scope are reflected as "Pending Content" in FASB ASC. This pending content is shown in text boxes below the paragraphs being amended in FASB ASC and includes links to the transition information. The pending content boxes are meant to provide users with information about how a paragraph will change when new guidance becomes authoritative. When an amended paragraph has been fully effective for six months, the outdated guidance will be removed, and the amended paragraph will remain without the pending content box. FASB will keep any outdated guidance in the applicable archive section of FASB ASC for historical purposes.

.19

Because not all entities have the same fiscal year-ends and certain guidance may be effective on different dates for public and nonpublic entities, the pending content will apply to different entities at different times. As such, pending content will remain in place within FASB ASC until the roll-off date. Generally, the roll-off date is six months following the latest fiscal year end for which the original guidance being amended or superseded by the pending content could be applied as specified by the transition guidance. For example, assume an ASU has an effective date for fiscal years beginning after November 15, 2012. The latest possible fiscal year end of an entity still eligible to apply the original guidance being amended or superseded by the pending content would begin November 15, 2012, and end November 14, 2013. Accordingly, the roll-off date would be May 14, 2014.

.20

Entities cannot disregard the pending content boxes in FASB ASC. Instead, all entities must review the transition guidance to determine when the pending content is applicable to them.

**Overall Objectives of the Auditor**

.21

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

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

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 require that the auditor disclaim an opinion or withdraw from the engagement, when withdrawal is possible under applicable law or regulation.

**Auditor Requirements**

**Ethical Requirements Relating to an Audit of Financial Statements**

.23

The auditor must be independent of the entity when performing an engagement in accordance with GAAS unless (a) GAAS provides otherwise or (b) the auditor is required by law or regulation to accept the engagement and report on the financial statements. When the auditor is not independent and neither (a) nor (b) are applicable, the auditor is precluded from issuing a report under GAAS.

.24

The auditor should comply with relevant ethical requirements relating to financial statement audit engagements. Ethical requirements consist of the [AICPA Code of Professional Conduct](https://www.aicpa.org) together with rules of state boards of accountancy and applicable regulatory agencies that are more restrictive.

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Because an audit engagement is in the public interest, AU-C section 200 requires 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 “Conceptual Framework for Independence” interpretation.

.26

The “Compliance With Standards Rule” requires an AICPA member who performs an audit (the auditor) to comply with standards promulgated by bodies designated by Council, which includes the ASB. Section 3115, "Independence," in this manual provides additional discussion on maintaining independence.

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QC section 10 sets out the firm’s responsibilities to establish and maintain its system of quality control for audit engagements, and to establish 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. AU-C section 220 addresses the engagement partner’s responsibilities regarding relevant ethical requirements. These include remaining alert for evidence of non-compliance with relevant ethical requirements by members of the engagement team, determining, in consultation with others in the firm as appropriate, the appropriate action if matters come to the engagement partner’s attention, through the firm’s system of quality control or otherwise, that indicate that members of the engagement team have not complied with relevant ethical requirements, and forming a conclusion on compliance with independence requirements that apply to the audit engagement. AU-C section 220 recognizes that the engagement team is entitled to rely on a firm’s system of quality control in meeting its responsibilities with respect to quality control procedures applicable to the individual audit engagement, unless the engagement partner determines that it is inappropriate to do so based on information provided by the firm or other parties.

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Additional discussion on a firm’s system of quality control can be found in section 10,000, "Quality Control," of this manual, including illustrative quality control forms and a reprint of the AICPA Practice Aid Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice.

Professional Skepticism

.29

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.
Professional skepticism includes being alert to the following, 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.

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.

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 when 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.

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. 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 require that the auditor investigate further and determine what modifications or additions to audit procedures are necessary to resolve the matter.
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

The auditor should also exercise professional judgment in planning and performing an audit of financial statements.

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. In particular, professional judgment is necessary regarding decisions about the following:

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

The distinguishing feature of professional judgment expected of an auditor is that such judgment is exercised based on competencies necessary to achieve reasonable judgments, developed by the auditor through relevant training, knowledge, and experience.
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 AU-C section 220, assists the auditor in making informed and reasonable judgments.

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.

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 findings or issues arising during the audit. 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**

To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, 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.

**Sufficiency and Appropriateness of Audit Evidence**

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) 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 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.

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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.

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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.

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Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby to enable the auditor to draw reasonable conclusions on which to base the auditor’s opinion, is a matter of professional judgment. AU-C section 500 and other relevant AU-C 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

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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.
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*

The *risk of material misstatement* is the risk that the financial statements are materially misstated prior to the audit.

The risks of material misstatement exist at two levels:

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

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.

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.
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.

**Inherent Risk**

Inherent risk is the susceptibility of a relevant 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.

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.

**Control Risk**

Control risk is 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.

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 and fair presentation 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 provide 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. GAAS do 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. 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.

AU-C section 315 establishes requirements and provides guidance on identifying and assessing the risks of material misstatement at the financial statement and assertion levels.

**Detection Risk**

 Detection risk is 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.

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.

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. The following matters 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:
• Adequate planning
• Proper assignment of personnel to the engagement team
• The application of professional skepticism
• Supervision and review of the audit work performed

AU-C sections 300 and 330 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

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 inherent limitations of an audit exist, 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 so as to achieve a balance between benefit and cost.

The Nature of Financial Reporting

The preparation and fair presentation 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 a range exists 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 that are dependent on predictions of future events. Nevertheless, GAAS require 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.

*The Nature of Audit Procedures*

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 fair 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*

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 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, FASB’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 so as to achieve a balance between benefit and 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 fraudulent or erroneous until proved otherwise.

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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.

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In light of the approaches described in paragraph .A53 of AU-C section 200 (discussed in the preceding paragraph), GAAS contain 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; 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.

Other Matters That Affect the Inherent Limitations of an Audit

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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 the following:

- Fraud, particularly fraud involving senior management or collusion. AU-C section 240 establishes requirements and provides guidance regarding the auditor’s responsibility to consider fraud in a financial statement audit.
- The existence and completeness of related party relationships and transactions. AU-C section 550 establishes requirements and provides guidance regarding the auditor’s responsibility to consider related party relationships and transactions in a financial statement audit.
The occurrence of non-compliance with laws and regulations. AU-C section 250 establishes requirements and provides guidance regarding the auditor’s responsibility to consider laws and regulations in a financial statement audit.

Future events or conditions that may cause an entity to cease to continue as a going concern. AU-C section 570 establishes requirements and provides guidance regarding the auditor’s responsibility in a financial statement audit to evaluate an entity’s ability to continue as a going concern.

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

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

Complying With AU-C Sections Relevant to the Audit

Nature of GAAS

The auditor should comply with all AU-C sections relevant to the audit. An AU-C section is relevant to the audit when the AU-C section is in effect and the circumstances addressed by the AU-C section exist.

GAAS provide the standards for the auditor’s work in fulfilling the overall objectives of the auditor. GAAS address the general responsibilities of the auditor, as well as the auditor’s further considerations relevant to the application of those responsibilities to specific topics. The scope, effective date, and any specific limitation of the applicability of a specific AU-C section are made clear in the AU-C
In certain audit engagements, the auditor also may be required to comply with other auditing requirements in addition to GAAS. GAAS do not override law or regulation that governs an audit of financial statements. In the event that such law or regulation differs from GAAS, an audit conducted only in accordance with law or regulation will not necessarily comply with GAAS.

The auditor may also conduct the audit in accordance with both GAAS and

- auditing standards promulgated by the PCAOB,
- International Standards on Auditing,
- *Government Auditing Standards*, or
- auditing standards of a specific jurisdiction or country.

In such cases, in addition to complying with each of the AU-C sections relevant to the audit, it may be necessary for the auditor to perform additional audit procedures in order to comply with the other auditing standards.

The auditor should have an understanding of the entire text of an AU-C section, including its application and other explanatory material, to understand its objectives and to apply its requirements properly.

*Contents of GAAS*

In addition to objectives and requirements, an AU-C 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-C section and definitions. The entire text of an AU-C section, therefore, is relevant to an understanding of the objectives stated in an AU-C section and the proper application of the requirements of an AU-C section.
When necessary, the application and other explanatory material provides further explanation of the requirements of an AU-C 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-C section. The auditor is required by paragraph .21 of AU-C section 200 to understand the application and other explanatory material; how the auditor applies the guidance in the engagement depends on the exercise of professional judgment in the circumstances consistent with the objective of the AU-C 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-C section.

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-C section or within the title and introduction of the appendix itself.

Introductory material may include, as needed, such matters as explanation of the following:

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

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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-C 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 Audits of Smaller, Less Complex Entities

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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

- concentration of ownership and management in a small number of individuals and
- one or more of the following:
  - Straightforward or uncomplicated transactions
  - Simple record keeping
  - Few lines of business and few products within business lines
  - Few internal controls
  - Few levels of management with responsibility for a broad range of controls
  - 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.
GAAS refer to the proprietor of a smaller entity who is involved in running the entity on a day-to-day basis as the owner-manager.

The auditor should not represent compliance with GAAS in the auditor’s report unless the auditor has complied with the requirements of AU-C section 200 and all other AU-C sections relevant to the audit.

Objectives Stated in Individual AU-C Sections

To achieve the overall objectives of the auditor, the auditor should use the objectives stated in individual AU-C sections in planning and performing the audit considering the interrelationships within GAAS to

a. determine whether any audit procedures in addition to those required by individual AU-C sections are necessary in pursuance of the objectives stated in each AU-C section and

b. evaluate whether sufficient appropriate audit evidence has been obtained.

Each AU-C 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-C sections serve to focus the auditor on the desired outcome of the AU-C section, while being specific enough to assist the auditor in

- understanding what needs to be accomplished and, when 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.

Objectives are to be understood in the context of the overall objectives of the auditor stated in paragraph .12 of AU-C section 200. 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.
In using the objectives, the auditor is required to consider the interrelationships among the AU-C sections. This is because, as indicated in paragraph .A58 of AU-C section 200, the AU-C sections in some cases address general responsibilities and in others address the application of those responsibilities to specific topics. For example, this section 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-C section. At a more detailed level, AU-C section 315 and AU-C section 330 contain, among other things, objectives and requirements that address 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-C section addressing specific aspects of the audit may expand on how the objectives and requirements of other AU-C sections are to be applied regarding the subject of that AU-C section, but does not repeat those objectives and requirements. For example, AU-C section 540 expands on how the objectives and requirements of AU-C section 315 and AU-C section 330 are to be applied regarding the subject of AU-C section 540, but AU-C section 540 does not repeat those objectives and requirements. Thus, in achieving the objective stated in AU-C section 540, the auditor considers the objectives and requirements of other relevant AU-C sections.

**Use of Objectives to Determine Need for Additional Audit Procedures**

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**

The auditor is required by paragraph .23b of AU-C section 200 to use the objectives stated in the relevant AU-C sections 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 .23b of AU-C section 200:

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

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When 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.

Complying With Relevant Requirements

.92

Subject to paragraph .26 of AU-C section 200, the auditor should comply with each requirement of an AU-C section unless, in the circumstances of the audit,

• the entire AU-C section is not relevant; or
• the requirement is not relevant because it is conditional and the condition does not exist.

.93

In some cases, an AU-C 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-C section 610A is relevant.

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Within a relevant AU-C 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 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 with governance, which depends on the existence and identification of such deficiencies, represents an
implicit conditional requirement.

In some cases, a requirement may be expressed as being conditional on applicable law or regulation. For example, the auditor may be required to withdraw from the audit engagement, when withdrawal is possible under applicable law or regulation, or the auditor may be required to perform a certain action, unless prohibited by law or regulation. Depending on the jurisdiction, the legal or regulatory permission or prohibition may be explicit or implicit.

**Defining Professional Responsibilities in GAAS**

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GAAS use the following two categories of professional requirements, identified by specific terms, to describe the degree of responsibility it imposes on auditors:

- **Unconditional requirements.** The auditor must comply with an unconditional requirement in all cases in which such requirement is relevant. GAAS use 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 a requirement is relevant except in rare circumstances discussed in paragraph .26 of AU-C section 200. GAAS use the word *should* to indicate a presumptively mandatory requirement.

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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 when the requirement is for a specific procedure to be performed and, in the specific circumstances of the audit, that procedure would be ineffective in achieving the intent of the requirement.

**Presumptively Mandatory Requirements**

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If an AU-C 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

AU-C section 230 establishes documentation requirements in those exceptional circumstances when the auditor departs from a relevant requirement. GAAS do not call for compliance with a requirement that is not relevant in the circumstances of the audit.

Interpretive Publications

The auditor should consider interpretive publications in planning and performing the audit.

Interpretive publications are not auditing standards. Interpretive publications are recommendations on the application of the 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 AU-C sections. AICPA Audit and Accounting Guides and Auditing Statements of Position are listed in AU-C appendix D, AICPA Audit and Accounting Guides and Statements of Position (AICPA, Professional Standards).

Other Auditing Publications

In applying the auditing guidance included in an other auditing publication, the auditor should, exercising professional judgment, assess the relevance and appropriateness of such guidance to the circumstances of the audit. Although the auditor determines the relevance of these publications, 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.

In determining whether an other auditing publication that has not been reviewed by the AICPA Audit and Attest Standards staff is appropriate
to the circumstances of the audit, 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.

.103

Other auditing publications include, among other publications, the following:

- Auditing practice releases
- AICPA Technical Questions and Answers
- AICPA Audit Risk Alerts

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. Other auditing publications are listed in AU-C appendix F, Other Auditing Publications (AICPA, Professional Standards).

Failure to Achieve an Objective

.104

If an objective in a relevant AU-C 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 (when withdrawal is possible under applicable law or regulation). Failure to achieve an objective represents a significant finding or issue requiring documentation in accordance with AU-C section 230.

.105

Whether an objective has been achieved is a matter for the auditor’s professional judgment. That judgment takes into account 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-C 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.

Audit documentation that meets the requirements of AU-C section 230 and the specific documentation requirements of other relevant AU-C 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.
AAM Section 3105

Planning the Engagement

This section contains the following references from AICPA Professional Standards:

- AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*
- AU-C section 210, *Terms of Engagement*
- AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*
- AU-C section 260, *The Auditor’s Communication With Those charged With Governance*
- AU-C section 300, *Planning an Audit*
- AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
- AU-C section 510, *Opening Balances—Initial Audit Engagements, Including Reaudit Engagements*
- AU-C section 600, *Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors)*
- AU-C section 705, *Modifications to the Opinion in the Independent Auditor’s Report*
- The “General Standards Rule” (ET sec. 1.300.001)

**Audit Planning**

**General**

.01

The planning phase is an important part of every engagement. The objective of the planning phase is to plan the audit such that it will be
performed in an effective manner.

.02

The need for planning is highlighted paragraph .01 of the “General Standards Rule,” which states in part that a member shall adequately plan and supervise the performance of professional services.

.03

AU-C section 300 establishes standards and provides guidance regarding the independent auditor’s responsibility to plan an audit of financial statements, including an initial audit engagement, in accordance with generally accepted auditing standards (GAAS).

.04

Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan. Adequate planning benefits the audit of financial statements in several ways, including the following:

- Helping the auditor identify and devote appropriate attention to important areas of the audit
- Helping the auditor identify and resolve potential problems on a timely basis
- Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner
- Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks and allocating team member responsibilities
- Facilitating the direction and supervision of engagement team members and the review of their work
- Assisting, when applicable, in coordination of work done by auditors of components and specialists

.05

Proper planning also enhances the productivity of engagement personnel and may result in a more profitable engagement.

.06
The nature and extent of planning activities will vary according to the size and complexity of the entity, the key engagement team member’s previous experience with the entity, and changes in circumstances that occur during the audit engagement.

.07

Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. Planning, however, includes consideration of the timing of certain activities and audit procedures that need to be completed prior to the performance of further audit procedures. For example, planning includes the need to consider, prior to the auditor’s identification and assessment of the risks of material misstatement, such matters as the following:

- The analytical procedures to be applied as risk assessment procedures
- A general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework
- The determination of materiality
- The involvement of specialists
- The performance of other risk assessment procedures

.08

The auditor may decide to discuss elements of planning with the entity’s management to facilitate the conduct and management of the audit engagement (for example, to coordinate some of the planned audit procedures with the work of the entity’s personnel). Although these discussions often occur, the overall audit strategy and the audit plan remain the auditor’s responsibility. When discussing matters included in the overall audit strategy or audit plan, care is required in order not to compromise the effectiveness of the audit. For example, discussing the nature and timing of detailed audit procedures with management may compromise the effectiveness of the audit by making the audit procedures too predictable.

.09

AU-C section 600 provides guidance that an auditor may find useful, adapted as necessary in the circumstances, when that auditor involves other auditors in the audit of financial statements that are not group financial statements. For example, an auditor may involve another auditor to observe the inventory count or inspect physical fixed assets at a remote location. Additional guidance regarding group audits can be found in Q&A sections 8800.01–.43 of section 8800, Audits of Group Financial Statements and Work of Others (AICPA Technical Questions and
Preliminary Engagement Activities

The auditor should undertake the following activities at the beginning of the current audit engagement:

a. Performing procedures required by paragraphs .13–.14 of AU-C section 220 regarding the continuance of the client relationship and the specific audit engagement

b. Evaluating compliance with relevant ethical requirements in accordance with AU-C section 220

c. Establishing an understanding of the terms of the engagement as required by AU-C section 210

Performing preliminary engagement activities at the beginning of the audit engagement assists the auditor in identifying and evaluating events or circumstances that may adversely affect the auditor’s ability to plan and perform the audit engagement.

Performing these preliminary engagement activities enables the auditor to plan an audit engagement for which

- the auditor maintains the necessary independence and ability to perform the engagement.
- the auditor has no issues with management integrity that may affect the auditor’s willingness to continue the engagement.
- the auditor has no misunderstanding with the entity about the terms of the engagement.

The auditor’s consideration of client continuance and relevant ethical requirements, including independence, occurs throughout the audit engagement as conditions and changes in circumstances occur. Performing initial procedures on both client continuance and evaluation of relevant ethical requirements (including independence) at the beginning of the current audit engagement means that they are completed prior to the performance of other significant activities for the current audit engagement. For continuing audit engagements, such initial procedures often
begin shortly after (or in connection with) the completion of the previous audit.

**Terms of the Engagement**

**Preconditions for an Audit**

.14

According to AU-C section 210, 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.

.15

In order to establish whether the preconditions for an audit are present, the auditor should

- determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable and
- obtain the agreement of management that it acknowledges and understands its responsibility
  — for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework;
  — 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
- to provide the auditor with
  - 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;
  - additional information that the auditor may request from management for the purpose of the audit; and
  - unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.
If the preconditions for an audit are not present, the auditor should discuss the matter with management. Unless the auditor is required by law or regulation to do so, the auditor should not accept the proposed audit engagement

- if the auditor has determined that the financial reporting framework to be applied in the preparation of the financial statements is unacceptable or

- if the agreement referred to in paragraph .06b of AU-C section 210 has not been obtained.

Considerations specific to smaller, less complex entities. One of the purposes of agreeing upon the terms of the audit engagement is to avoid misunderstanding about the respective responsibilities of management and the auditor. For example, when the auditor or a third party has assisted with drafting the financial statements, it may be useful to remind management that the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework remains its responsibility.

Agreement on Audit Engagement Terms

The auditor should agree upon the terms of the audit engagement with management or those charged with governance, as appropriate. The roles of management and those charged with governance in agreeing upon the terms of the audit engagement for the entity depend on the governance structure of the entity and relevant law or regulation. Depending on the entity’s structure, the agreement may be with management, those charged with governance, or both. When the agreement on the terms of engagement is only with those charged with governance, nonetheless in accordance with paragraph .06 of AU-C section 210, the auditor is required to obtain management’s agreement that it acknowledges and understands its responsibilities. When a third party has contracted for the audit of the entity’s financial statements, agreeing to the terms of the audit with management of the entity is necessary in order to establish that the preconditions for an audit are present.

The agreed-upon terms of the audit engagement should be documented in an audit engagement letter or other suitable form of written agreement and should include the following:

a. The objective and scope of the audit of the financial statements
b. The responsibilities of the auditor

c. The responsibilities of management

d. A statement that because of the inherent limitations of an audit, together with the inherent limitations of internal control, an unavoidable risk exists that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with GAAS

e. Identification of the applicable financial reporting framework for the preparation of the financial statements

f. Reference to the expected form and content of any reports to be issued by the auditor and a statement that circumstances may arise in which a report may differ from its expected form and content

**Form and Content of the Audit Engagement Letter**

The form and content of the audit engagement letter may vary for each entity. Information included in the audit engagement letter on the auditor’s responsibilities may be based on paragraphs .04–.10 of AU-C section 200. Paragraph .06b of AU-C section 210 addresses the description of the responsibilities of management. In addition to including the matters required by paragraph .10 of AU-C section 210, an audit engagement letter may make reference to, for example, the following:

- Elaboration of the scope of the audit, including reference to applicable legislation, regulations, GAAS, and ethical and other pronouncements of professional bodies to which the auditor adheres

- The form of any other communication of results of the audit engagement

- Arrangements regarding the planning and performance of the audit, including the composition of the audit team

- The expectation that management will provide written representations (paragraph .A11 of AU-C section 210)

- The agreement of management to make available to the auditor draft financial statements and any accompanying other information in time to allow the auditor to complete the audit in accordance with the proposed timetable

- The agreement of management to inform the auditor of events occurring or facts discovered subsequent to the date of the financial statements, of which management may become aware, that may affect the financial statements

- The basis on which fees are computed and any billing arrangements
- A request for management to acknowledge receipt of the audit engagement letter and to agree to the terms of the engagement outlined therein, as may be evidenced by their signature on the engagement letter.

21

When relevant, the following points also could be made in the audit engagement letter:

- Arrangements concerning the involvement of other auditors and specialists in some aspects of the audit.
- Arrangements concerning the involvement of internal auditors and other staff of the entity.
- Arrangements to be made with the predecessor auditor, if any, in the case of an initial audit.
- Any restriction of the auditor’s liability when not prohibited.
- Any obligations of the auditor to provide audit documentation to other parties.
- Additional services to be provided, such as those relating to regulatory requirements.
- A reference to any further agreements between the auditor and the entity.

Additional Considerations

22

The following matters may be considered while preparing an audit engagement letter:

- Whether circumstances preclude an unmodified opinion, as in these examples:
  - The auditor is retained after the beginning of the client's fiscal year, did not observe inventories or confirm receivables at the beginning of the year and was unable to gain satisfaction through application of alternative procedures.
  - The client imposes restrictions on the scope of the audit. (See AU-C section 705.)
  - Significant litigation or other matters exist which may affect the opinion.
- Whether the fee should be stated as a range, in hourly rates, as standard per diem charges for the engagement, or as a maximum or flat
The person or persons to whom reports should be addressed

The number of copies needed of the report and the people to whom they are to be distributed

Deadlines for reports or analyses

Timing of fieldwork

Out-of-pocket costs

The condition of records or circumstances other than those contemplated in the engagement letter (for example, deficient internal control)

A retainer

One time engagements

Start-up costs when the client changes auditors

Underwriters' requirements in connection with public offerings

Often, entities that have never been audited resist signing a client representation letter. To avoid client resistance at the end of the audit, many firms notify the client in the audit engagement letter that they will be asked to sign a client representation letter.

If the auditor has reason to believe the client may publish all or a portion of an audit report, he or she may advise the client (preferably in the audit engagement letter) that firm policy is to read printer's proofs of the report and any other accompanying material. This precaution protects both the client and the auditor against condensation of financial statements, omission of footnotes, erroneous layout, and other errors such as misstatement of figures used in a president's letter, other narrative, or statistics.
It is considered best practice for the auditor to establish the understanding with the client and prepare the audit engagement letter before any significant work takes place on the engagement. The partner may personally present the letter to the client to ensure that a complete understanding has been achieved. The understanding or a signed copy of the audit engagement letter may be filed with the engagement's current working papers and permanent file.

**Key Point**

Be careful when using a proposal or preliminary audit engagement letter for a client. If the letter describes additional services that are not finally agreed upon, it may be used in litigation as an indication of inadequate performance by you on the engagement. It is a best practice to always make sure that a final engagement letter is issued in such circumstances.

The engagement letter is generally addressed to those charged with governance, the chief executive, or whoever retained the firm. If the engagement letter also serves as the method of communicating the auditor’s responsibilities under AU-C section 260 the addressee should include those persons charged with governance. The engagement partner may sign the letter on behalf of the firm. The client representative responsible for the engagement signs the letter denoting agreement with the contract. The original letter may be maintained in the engagement documentation. A copy of the letter is given to the client.

Following is a list of common engagement letter deficiencies:

- Reference in the letter to audit of the books and records rather than to audit of financial statements
- Adverse comments about other firms
- Failure to specify *in detail* the services to be rendered when a maximum fee is quoted
- Inclusion of a review of internal control as one of the services when what is really intended is an understanding of internal control as required by auditing standards
- Failure to identify that accounting or other problems may exist that might have an effect on the opinion
- Failure to change, in writing, the terms of the engagement when conditions are found to be different (such as the inability to express an opinion without extensive additional auditing because internal control was found to be deficient)
• Failure to include fee basis and payment terms
• Failure to identify subsidiaries
• Failure to identify specific tax returns to be prepared
• Failure to document the scope of the engagement

Fee Issues

.28

Two types of fee arrangements, contingent fees and commissions, are prohibited when the arrangement involves certain attest clients, even though the fee is not related to an attest service.

.29

A contingent fee is an arrangement whereby (a) no fee is charged unless a specified result is attained or (b) the amount of the fee otherwise depends on the results of your firm's services. Some examples of contingent fees are the following:

• Your firm receives a finder's fee for helping a client locate a buyer for one of the client's assets.

• Your firm performs a consulting engagement to decrease a client's operating costs. The fee is based on a percentage of the cost reduction that the client achieves as a result of your service.

.30

The following are exceptions:

• Fees fixed by a court or other public authority

• In tax matters, fees based on the results of judicial proceedings or the findings of governmental agencies

.31

A commission is any compensation paid to you or your firm for (a) recommending or referring a third party's product or service to a client or
(b) recommending or referring a client's product or service to a third party. Permitted commissions shall be disclosed to the person or entity you recommend or refer a product or service to.

Examples of commissions are if you or your firm

- refers a client to a financial planning firm that pays you a commission for the referral.
- sells accounting software to a client and receives a percentage of the sales price (a commission) from a software company.
- refers a nonclient to an insurance company client, which pays you a percentage of any premiums subsequently received (a commission) from the nonclient.

The AICPA rule provides an exception for referral fees for recommending or referring a CPA’s services to another entity person or entity. That is, you may (a) receive a fee for referring the services of a CPA to any person or entity or (b) if you are a CPA, pay a fee to obtain a client provided you disclose such receipt or payment to the client. Referral fees are not considered commissions under these specific circumstances. You must inform the client if you receive or pay a referral fee.

You and your firm may not have commission or contingent fee arrangements with a client when your firm also provides one of the following services to a client:

- An audit of financial statements
- A review of financial statements
- A compilation of financial statements when a third party (for example, a bank or investor) will rely on the financial statements and the report does not disclose a lack of independence
- An examination of prospective financial statements
You and your firm may have commission and contingent fee arrangements with persons associated with a client—such as officers, directors, and principal shareholders—or with a benefit plan that is sponsored by a client (that is, the plan itself is not a client). In For example, you or your firm may receive a commission from a nonclient insurer if you refer an officer of an attest client to the insurer and the officer purchases a policy. Even when permitted, the existence of a commission arrangement must be disclosed to the person (or entity) to whom the commission relates.

Sample Engagement Letters


Acceptance of a Change in the Terms of the Audit Engagement

The auditor should not agree to a change in the terms of the audit engagement when no reasonable justification for doing so exists. If, prior to completing the audit engagement, the auditor is requested to change the audit engagement to an engagement for which the auditor obtains a lower level of assurance, the auditor should determine whether reasonable justification for doing so exists. If the terms of the audit engagement are changed, the auditor and management should agree on and document the new terms of the engagement in an engagement letter or other suitable form of written agreement.

If the auditor concludes that no reasonable justification for a change of the terms of the audit engagement exists and is not permitted by management to continue the original audit engagement, the auditor should

a. withdraw from the audit engagement when possible under applicable law or regulation,

b. communicate the circumstances to those charged with governance, and

c. determine whether any obligation, either legal, contractual, or otherwise, exists to report the circumstances to other parties, such as owners, or regulators.

Involvement of Key Engagement Team Members
The engagement partner and other key members of the engagement team should be involved in planning the audit, including planning and participating in the discussion among engagement team members. The involvement of the engagement partner and other key members of the engagement team in planning the audit draws on their experience and insight, thereby enhancing the effectiveness and efficiency of the planning process. The engagement partner may delegate portions of the planning and supervision of the audit to other firm personnel.

**Planning Activities**

**Forming an Audit Strategy**

*The Overall Audit Strategy*

- The auditor should establish an overall audit strategy that sets the scope, timing, and direction of the audit and that guides the development of the audit plan. In establishing the overall audit strategy, the auditor should
  
  a. identify the characteristics of the engagement that define its scope;
  
  b. ascertain the reporting objectives of the engagement in order to plan the timing of the audit and the nature of the communications required;
  
  c. consider the factors that, in the auditor’s professional judgment, are significant in directing the engagement team’s efforts;
  
  d. consider the results of preliminary engagement activities and, when applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and
  
  e. ascertain the nature, timing, and extent of resources necessary to perform the engagement.

- Once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor’s resources. The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes but are closely interrelated because changes in one may result in consequential changes to the other.
The appendix to AU-C section 300 provides examples of matters the auditor may consider in establishing the overall audit strategy. Many of these matters also will influence the auditor’s detailed audit plan.

Considerations Specific to Smaller, Less Complex Entities

In audits of smaller entities, the entire audit may be conducted by a very small audit team. Many audits of smaller entities involve the engagement partner (who may be a sole practitioner) working with one engagement team member (or without any engagement team members). With a smaller team, coordination of, and communication between, team members is easier. Establishing the overall audit strategy for the audit of a smaller entity need not be a complex or time consuming exercise; it varies according to the size and complexity of the entity, the complexity of the audit, and the size of the engagement team. For example, a brief memorandum prepared at the completion of the previous audit, based on a review of the working papers and highlighting issues identified in the audit just completed, updated in the current period, based on discussions with the owner-manager, can serve as the documented audit strategy for the current audit engagement if it covers the matters noted in paragraph .07 of AU-C section 300.

Communications With Those Charged With Governance and Management

AU-C section 260 explains that, among other matters, the auditor should communicate with those charged with governance (a) the auditor’s responsibilities under GAAS and (b) an overview of the planned scope and timing of the audit.

The Audit Plan

The auditor should develop an audit plan that includes a description of the following:

a. The nature and extent of planned risk assessment procedures, as determined under AU-C section 315

b. The nature, timing, and extent of planned further audit procedures at the relevant assertion level, as determined under AU-C section 330

c. Other planned audit procedures that are required to be carried out so that the engagement complies with GAAS
Direction, Supervision, and Review

A6

The nature, timing, and extent of the direction and supervision of engagement team members and review of their work vary, depending on many factors, including the following:

- The size and complexity of the entity
- The area of the audit
- The assessed risks of material misstatement (for example, an increase in the assessed risk of material misstatement for a given area of the audit ordinarily requires a corresponding increase in the extent and timeliness of direction and supervision of engagement team members and a more detailed review of their work)
- The capabilities and competence of the individual team members performing the audit work

Accordingly, the auditor should plan the nature, timing, and extent of direction and supervision of engagement team members and the review of their work.

A7

AU-C section 220 establishes requirements and provides guidance on the direction, supervision, and review of audit work.

Changes to Planning Decisions During the Course of the Audit

A8

As a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan and, thereby, the resulting planned nature, timing, and extent of further audit procedures, based on the revised consideration of assessed risks. This may be the case when information comes to the auditor’s attention that differs significantly from the information available when the auditor planned the audit procedures. For example, audit evidence obtained through the performance of substantive procedures may contradict the audit evidence obtained through tests of controls. Accordingly, the auditor also should update and change the overall audit strategy and audit plan, as necessary, during the course of the audit.

Determining the Extent of Involvement of Professionals Possessing Specialized Skills
The auditor should consider whether specialized skills are needed in performing the audit. If specialized skills are needed, the auditor should seek the assistance of a professional possessing such skills, who either may be on the auditor’s staff or an outside professional. In such circumstances, the auditor should have sufficient knowledge to communicate the objectives of the other professional’s work; evaluate whether the specified audit procedures will meet the auditor's objectives; and evaluate the results of the audit procedures applied as they relate to the nature, timing, and extent of further planned audit procedures.

An auditor may decide to seek the assistance of a professional with specialized skills necessary to complete various aspects of the engagement. These professionals may include valuation experts, appraisers, actuaries, tax specialists, and IT professionals. For example, the use of professionals possessing IT skills to determine the effect of IT on the audit, to understand the IT controls, or to design and perform tests of IT controls or substantive procedures is a significant aspect of many audit engagements. In determining whether such a professional is needed on the audit team, the auditor may consider such factors as the following:

- The complexity of the entity’s systems and IT controls and the manner in which they are used in conducting the entity’s business
- The significance of changes made to existing systems, or the implementation of new systems
- The extent to which data is shared among systems
- The extent of the entity’s participation in electronic commerce
- The entity’s use of emerging technologies
- The significance of audit evidence that is available only in electronic form

Audit procedures that the auditor may assign to a professional possessing IT skills include inquiring of an entity’s IT personnel how data and transactions are initiated, authorized, recorded, processed, and reported and how IT controls are designed; inspecting systems documentation; observing the operation of IT controls; and planning and performing tests of IT controls.

Additional Considerations in Initial Audit Engagements
The auditor should undertake the following activities prior to starting an initial audit:

a. Perform procedures required by AU-C section 220

b. Communicate with the predecessor auditor when there has been a change of auditors, in accordance with AU-C section 210

The purpose and objective of planning the audit are the same whether the audit is an initial or recurring engagement. However, for an initial audit, the auditor may need to expand the planning activities because the auditor does not have the previous experience with the entity that is considered when planning recurring engagements. For an initial audit engagement, additional matters the auditor may consider in establishing the overall audit strategy and audit plan include the following:

- Arrangements to be made with the predecessor auditor (for example, to review the predecessor auditor’s working papers [paragraphs .07 and .A2–.A11 of AU-C section 510])

- Any major issues (including the application of accounting principles or auditing and reporting standards) discussed with management in connection with the initial selection as auditor, the communication of these matters to those charged with governance, and how these matters affect the overall audit strategy and audit plan

- The audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances (paragraph .08 of AU-C section 510)

- Other procedures required by the firm’s system of quality control for initial audit engagements (for example, the firm’s system of quality control may require the involvement of another partner or senior individual to review the overall audit strategy prior to commencing significant audit procedures or to review reports prior to their issuance)

**Investigatory Procedures for Individuals**

When credit information is requested about individuals who are new clients, the investigatory procedures are subject to the Fair Credit Reporting Act.
Under the Fair Credit Reporting Act, an individual is informed in writing that an investigative consumer report, including information about the individual's character, general reputation, personal characteristics, and mode of living is being made. The individual is also advised, within three days of the time the report is requested, that he or she may, within a reasonable time, by written request, be furnished disclosure of the nature and scope of the investigation.

Documentation

.56

The auditor should include in the audit documentation the following:

a. The overall audit strategy

b. The audit plan

c. Any significant changes made during the audit engagement to the overall audit strategy or the audit plan and the reasons for such changes

.57

The documentation of the overall audit strategy is a record of the key decisions considered necessary to properly plan the audit and communicate significant issues to the engagement team. For example, the auditor may summarize the overall audit strategy in the form of a memorandum that contains key decisions regarding the overall scope, timing, and conduct of the audit.

.58

The documentation of the audit plan is a record of the planned nature, timing, and extent of risk assessment procedures and further audit procedures at the relevant assertion level in response to the assessed risks. It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance. The auditor may use standard audit programs or audit completion checklists, tailored as needed to reflect the particular engagement circumstances.

.59

A record of the significant changes to the overall audit strategy and the audit plan and resulting changes to the planned nature, timing, and extent of audit procedures explain why the significant changes were made and why the overall strategy and audit plan were finally adopted for the audit. It also reflects the appropriate response to the significant changes occurring during the audit.
Client Assistance Package

When planning the audit engagement the auditor may consider preparing a client assistance package (CAP) or produced by client listing (PBC) and providing it to the client. The CAP or PBC is usually tailored to each specific engagement. The following is a list of analyses, schedules and other items that are often requested from the client prior to the start of an audit engagement:

### Client Assistance Package (CAP)

#### Client: ________________________________

#### Audit Date: ________________

<table>
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<tr>
<th>Request Reference</th>
<th>Requested Support</th>
<th>Requested on</th>
<th>Requested to be received by</th>
<th>Received by auditor on</th>
<th>Status (Open, Partial, Closed)</th>
<th>Comments</th>
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<td>The general ledger as of the audit date.</td>
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<td>A reconciliation for each bank account.</td>
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<td>C.1</td>
<td>A trade accounts receivable aging as of the audit date.</td>
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<td>C.2</td>
<td>Accounts receivable confirmation letters, using template to be provided by the auditor.</td>
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<tr>
<td>C.3</td>
<td>A schedule of accounts receivable from officers and employees.</td>
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<tr>
<td>C.4</td>
<td>A schedule of bad debts written off during the year.</td>
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<td>D.1</td>
<td>A schedule of notes receivable as of the audit date. The notes should be available for inspection.</td>
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<td>E.1</td>
<td>An inventory listing as of the audit date.</td>
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<td>F.1</td>
<td>An analysis of transactions affecting marketable securities.</td>
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<td>G.1</td>
<td>An insurance schedule. The policies should be available for inspection.</td>
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<td>H.1</td>
<td>A rollforward schedule of property and</td>
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<td>H.2</td>
<td>A depreciation schedule.</td>
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<tr>
<td>H.3</td>
<td>Copies of all leases, including equipment rental contracts, should be available for inspection.</td>
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<tr>
<td>H.4</td>
<td>A schedule of repairs and maintenance in excess of $____.</td>
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<tr>
<td>I.1</td>
<td>A schedule of life insurance of officers.</td>
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<tr>
<td>J.1</td>
<td>A schedule of accounts payable as of the audit date. The creditor’s regular monthly statements for [date] should be retained and made available.</td>
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<td>K.1</td>
<td>A schedule of notes payable as of the audit date.</td>
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<td>L.1</td>
<td>A schedule of all transactions to partners’ capital and drawing accounts.</td>
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<tr>
<td>L.2</td>
<td>A copy of the partnership agreement or corporate charter should be available for inspection.</td>
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<tr>
<td>M.1</td>
<td>A reconciliation of payroll accounts to the payroll system.</td>
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<tr>
<td>M.2</td>
<td>Copies of employment contracts with salesmen or executives should be available for inspection.</td>
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<tr>
<td>M.3</td>
<td>Copies of pension, profit sharing, deferred compensation, stock option agreements, and letters of acceptance from the Treasury Department, should be available for inspection.</td>
<td></td>
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<tr>
<td>M.4</td>
<td>A schedule of each officer’s salary and expense account payments.</td>
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<tr>
<td>N.1</td>
<td>A schedule of contributions.</td>
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<tr>
<td>O.1</td>
<td>A schedule of transactions with affiliated enterprises.</td>
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</tbody>
</table>
A schedule of tax expense.

A schedule of professional fees, including legal fees.

The corporate stock book and minutes should be up to date and available for inspection.

Footnotes (AAM Section 3105 — Planning the Engagement):

fn 1 Also see the “Contingent Fee Arrangements With an Investment Advisory Services Nonattest Client That Is Related to a Client” interpretation (AICPA, Professional Standards, ET sec 1.510.040) of the AICPA Code of Professional Conduct.
AAM Section 3110

Assigning Personnel to the Engagement and Supervision

This section contains the following references from AICPA Professional Standards:

- AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*
- AU-C section 230, *Audit Documentation*
- QC section 10, *A Firm’s System of Quality Control*

General Comments

.01

Engagement planning includes procedures for assigning personnel to the engagement. Having procedures established provides the firm with reasonable assurance that work will be performed by persons having the degree of technical training and proficiency required in the circumstances. Generally, the more able and experienced the personnel assigned to a particular engagement, the less need for direct supervision.

.02

Some procedures regarding assignment of personnel to the engagement are discussed in this section. The specific procedures adopted by a firm would not necessarily include all the procedures or be limited to those discussed. Overall firm guidance for assigning personnel to engagements is addressed in the Practice Aid *Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (www.aicpa.org/interestareas/frc/pages/enhancingauditqualitypracticeaid.aspx), and in "A Firm’s System of Quality Control" in section 10,200 of this manual. Sample quality control forms are available at section 10,300 of this manual, which are helpful in assigning personnel to engagements.

Engagement Planning Procedures

Audit Assignment Controls
A time budget for the engagement is prepared to determine manpower requirements and to schedule field work. The engagement partner may approve the time budget prior to the beginning of field work. A time budget may have columns for budgeted time (in hours) for preliminary and final field work. Time budget forms differ depending upon firm preference and needs (see paragraphs .01–.02 of section 3160 of this manual for "Audit Time Budget—Sample A" and "Audit Time Budget—Sample B").

Other alternatives include longer, more detailed sets of forms. These forms combine the features of a time budget, a source document for staff scheduling, and a job progress report that compares each assigned person's actual hours against the budget. Some firms use a shorter, less detailed form for jobs of less than a predetermined number of staff hours (for example, 100 hours) and a longer form for jobs requiring more time (see paragraph .04 of section 3160 of this manual for "Audit Status Analysis"). Some firms use a weekly (or daily) progress report (see paragraph .03 of section 3160 of this manual, for example). This report, submitted by the auditor in charge, shows the time actually spent in relation to the estimate, the estimated additional time required, and the estimated variance from the original estimate.

Keeping the time budget and progress report current as the assignment progresses is vital for identifying and controlling timing because it is applied so that it can be compared to the budgeted time for that phase of the engagement. The time budget and progress report is carried in the working papers file and is filled in regularly by the auditor in charge for all persons applying time on the engagement.

**Auditor Requirements**

**Assignment of Engagement Team**

The engagement partner should be satisfied that the engagement team and any auditor’s external specialists, collectively, have the appropriate competence and capabilities to

a. perform the audit engagement in accordance with professional standards and applicable legal and regulatory requirements and

b. enable an auditor’s report that is appropriate in the circumstances to be issued.
A person with expertise in a specialized area of accounting or auditing is a member of the engagement team if that person performs audit procedures on the engagement. This applies whether that person is an employee of the firm or a nonemployee engaged by the firm. However, a person with such expertise is not a member of the engagement team if that person’s involvement with the engagement is only consultation.

.08

When considering the appropriate competence and capabilities expected of the engagement team as a whole, the engagement partner may take into consideration such matters as the team’s

- understanding of, and practical experience with, audit engagements of a similar nature and complexity through appropriate training and participation.
- understanding of professional standards and applicable legal and regulatory requirements.
- technical expertise, including expertise with relevant IT and specialized areas of accounting or auditing.
- knowledge of relevant industries in which the entity operates.
- ability to apply professional judgment.
- understanding of the firm’s quality control policies and procedures.

Engagement Performance

Direction, Supervision, and Performance

.09

The engagement partner should take responsibility for the following:

a. The direction, supervision, and performance of the audit engagement in compliance with professional standards, applicable legal and regulatory requirements, and the firm’s policies and procedures

b. The auditor’s report being appropriate in the circumstances
Direction of the engagement team involves informing the members of the engagement team of matters such as the following:

- Their responsibilities, including the need to comply with relevant ethical requirements and to plan and perform an audit with professional skepticism as required by AU-C section 200
- Responsibilities of respective partners when more than one partner is involved in the conduct of an audit engagement
- The objectives of the work to be performed
- The nature of the entity’s business
- Risk-related issues
- Problems that may arise
- The detailed approach to the performance of the engagement

Discussion among members of the engagement team allows team members to raise questions so that appropriate communication can occur within the engagement team.

.11

Appropriate teamwork and training assist members of the engagement team to clearly understand the objectives of the assigned work.

.12

Supervision includes matters such as the following:

- Tracking the progress of the audit engagement
- Considering the competence and capabilities of individual members of the engagement team, including whether they have sufficient time to carry out their work, they understand their instructions, and the work is being carried out in accordance with the planned approach to the audit engagement
- Addressing significant findings or issues arising during the audit engagement, considering their significance, and modifying the planned approach appropriately
Identifying matters for consultation or consideration by qualified engagement team members during the audit engagement

Considerations Relevant When a Member of the Engagement Team With Expertise in a Specialized Area of Accounting or Auditing Is Used

.13

When the engagement team includes a member with expertise in a specialized area of accounting or auditing, direction, supervision, and review of that engagement team member’s work is the same as for any other engagement team member and may include matters such as the following:

- Agreeing with that member upon the nature, scope, and objectives of that member’s work and the respective roles of, and the nature, timing, and extent of communication between, that member and other members of the engagement team
- Evaluating the adequacy of that member’s work, including the relevance and reasonableness of that member’s findings or conclusions and the consistency of those findings or conclusions with other audit evidence

Review

.14

The engagement partner should take responsibility for reviews being performed in accordance with the firm’s review policies and procedures.

.15

Under QC section 10 the firm’s review responsibility policies and procedures are determined on the basis that suitably experienced team members review the work of other team members. The engagement partner may delegate part of the review responsibility to other members of the engagement team, in accordance with the firm’s system of quality control.

.16

A review consists of consideration of whether, for example

- the work has been performed in accordance with professional standards and applicable legal and regulatory requirements;
- significant findings or issues have been raised for further consideration;
• appropriate consultations have taken place and the resulting conclusions have been documented and implemented;

• the nature, timing, and extent of the work performed is appropriate and without need for revision;

• the work performed supports the conclusions reached and is appropriately documented;

• the evidence obtained is sufficient and appropriate to support the auditor’s report; and the objectives of the engagement procedures have been achieved.

.17

On or before the date of the auditor’s report, the engagement partner should, through a review of the audit documentation and discussion with the engagement team, be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor’s report to be issued.

.18

Timely reviews of the following by the engagement partner at appropriate stages during the engagement allow significant findings or issues to be resolved on a timely basis to the engagement partner’s satisfaction on or before the date of the auditor’s report:

• Critical areas of judgment, especially those relating to difficult or contentious matters identified during the course of the engagement

• Significant risks

• Other areas that the engagement partner considers important

The engagement partner need not review all audit documentation but may do so. However, as required by AU-C section 230 the partner documents the extent and timing of the reviews.

Consultation

.19

The engagement partner should

a. take responsibility for the engagement team undertaking appropriate consultation on difficult or contentious matters;
b. be satisfied that members of the engagement team have undertaken appropriate consultation during the course of the engagement, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm;

c. be satisfied that the nature and scope of such consultations are agreed with, and conclusions resulting from such consultations are understood by, the party consulted; and

d. determine that conclusions resulting from such consultations have been implemented.

.20

Members of the engagement team have a professional responsibility to bring to the attention of appropriate personnel matters that, in their professional judgment, are difficult or contentious and may require consultation.

.21

Effective consultation on significant technical, ethical, and other matters within the firm or, when applicable, outside the firm can be achieved when those consulted

- are given all the relevant facts that will enable them to provide informed advice and
- have appropriate knowledge, authority, and experience.

.22

The engagement team may consult outside the firm (for example, when the firm lacks appropriate internal resources). The engagement team may take advantage of advisory services provided by other firms, professional and regulatory bodies, or commercial organizations that provide relevant quality control services.

**Engagement Quality Control Review**

.23

For those audit engagements, if any, for which the firm has determined that an engagement quality control review is required, the engagement partner should

a. determine that an engagement quality control reviewer has been appointed;
b. discuss significant findings or issues arising during the audit engagement, including those identified during the engagement quality control review, with the engagement quality control reviewer; and

c. not release the auditor’s report until the completion of the engagement quality control review.

.24

The engagement quality control reviewer should perform an objective evaluation of the significant judgments made by the engagement team and the conclusions reached in formulating the auditor’s report. This evaluation should involve

a. discussion of significant findings or issues with the engagement partner;

b. reading the financial statements and the proposed auditor’s report;

c. review of selected audit documentation relating to the significant judgments the engagement team made and the related conclusions it reached; and

d. evaluation of the conclusions reached in formulating the auditor’s report and consideration of whether the proposed auditor’s report is appropriate.

Consideration Specific to Smaller, Less Complex Entities

.25

An engagement quality control review is required for audit engagements that meet the criteria established by the firm that subjects engagements to an engagement quality control review. In some cases, none of the firm’s audit engagements may meet the criteria that would subject them to such a review.

Differences of Opinion

.26

If differences of opinion arise within the engagement team; with those consulted; or, when applicable, between the engagement partner and the engagement quality control reviewer, the engagement team should follow the firm’s policies and procedures for resolving differences of opinion.
Documentation

.27

The auditor should include in the audit documentation the following:

- Issues identified with respect to compliance with relevant ethical requirements and how they were resolved
- Conclusions on compliance with independence requirements that apply to the audit engagement and any relevant discussions with the firm that support these conclusions
- Conclusions reached regarding the acceptance and continuance of client relationships and audit engagements
- The nature and scope of, and conclusions resulting from, consultations undertaken during the course of the audit engagement

.28

The engagement quality control reviewer should document, for the audit engagement reviewed

a. that the procedures required by the firm’s policies on engagement quality control review have been performed;

b. the date that the engagement quality control review was completed; and

c. that the reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments that the engagement team made and the conclusions it reached were not appropriate.

.29

Documentation of consultations with other professionals involving difficult or contentious matters that is sufficiently complete and detailed contributes to an understanding of

- the issue on which consultation was sought and

- the results of the consultation, including any decisions made, the basis for those decisions, and how they were implemented.

.30
AU-C section 230 establishes requirements and provides guidance regarding the auditor’s responsibility to prepare audit documentation for an audit of financial statements. Paragraph .A9 of AU-C section 230 states that it is neither necessary nor practicable for the auditor to document every matter considered, or professional judgment made, in an audit.
AAM Section 3115

Independence

This section contains the following references from AICPA Professional Standards:

- ET section 0.400, Definitions
- The “Independence Rule” (ET sec. 1.200.001)
- The interpretations in the “Financial Interests” subtopic (ET sec. 1.240) of the “Independence Rule”
- The “Client Affiliates” interpretation (ET sec. 1.224.010)
- The interpretations in the “Nonattest Services” subtopic (ET sec. 1.295) of the “Independence Rule”
- The “General Requirements for Performing Nonattest Services” interpretation (ET sec. 1.295.040)
- The “Cumulative Effect on Independence When Providing Multiple Nonattest Services” interpretation (ET sec. 1.295.020)
- The “Networks and Network Firms” interpretation (ET sec. 1.220.010)
- The “Subsequent Employment or Association With an Attest Client” interpretation (ET sec. 1.279.020)
- QC section 10, A Firm’s System of Quality Control

This section contains the following reference from other authoritative guidance:

- FASB Accounting Standards Codification (ASC) 810, Consolidation

General Comments

.01
In accordance with the “Independence Rule” of the AICPA Code of Professional Conduct, a member in public practice shall be independent in the performance of professional services, as required by standards promulgated by council. This includes, but is not limited to, attest engagements. Also note that additional requirements exist for public companies and companies subject to other governmental oversight. Attest engagements are those in which your firm attests—or affirms—that a client's financial or other information is reasonably stated. Examples of attest services are

- financial statement audits,
- financial statement reviews, and
- other attest services as defined in the Statements on Standards for Attestation Engagements.

.02

Third parties—investors, creditors, and others—rely on your firm's attestations about a client's financial information when making various business decisions. Therefore, attest services have value for third parties only if an independent firm renders the services. Accordingly, AICPA Professional Standards states that the auditor must maintain independence in mental attitude in all matters relating to the audit; therefore, your firm may perform attest services for a client only when it is independent of that client. Independence is not required to perform the following services, if these are the only services your firm provides to a client:

a. Tax preparation and advice

b. Consulting services (such as tax consulting or personal financial planning)

.03

Engagement planning includes procedures to provide the firm with reasonable assurance that all persons required to maintain independence, to the extent required by the AICPA Code of Professional Conduct and the regulations of other organizations, as applicable (for example, the SEC, and the Department of Labor), do so. The interpretations and rulings under the “Independence Rule” of the AICPA Code of Professional Conduct contain examples of instances wherein a firm's independence will be considered to be impaired or not impaired.

.04

As stated in the following text, audit firms that perform audits of or perform other attest services for public companies or other SEC registrants should consult the independence rules of the SEC and the PCAOB.
Other organizations that have established other independence requirements that a member should consult if applicable include the following:

- State boards of accountancy
- State CPA societies
- Federal and state agencies, such as the Governmental Accountability Office (GAO)

Generally, the AICPA independence rules will apply to you in all situations involving an attest client. If an additional set of rules governing an engagement also applies, you should comply with the most restrictive rule or the most restrictive portions of each rule.

Maintaining Your Independence

Maintaining your independence is your responsibility, not your firm's. As part of its quality control system, the firm is often required to address independence matters; however, ultimately it is up to you to follow firm policies and the independence rules. Many firms require you to certify your independence on a regular basis. The following are some suggestions that will help you to complete and sign that certification in good faith.

Gain an understanding of the independence rules and firm policies. As a prerequisite to establishing and maintaining the independence, a good, working understanding of the basic independence rules is essential. Accordingly, in addition to this brief discussion about independence, CPAs should also consult and understand the AICPA Code of Professional Conduct. It is also important to be aware of the circumstances in which you and your immediate family meet the definition of a covered member (discussed in the following section in greater detail) and of the types of relationships you and your immediate family may have with the firm's clients that could impair independence. If you have any questions about independence matters, you may consult with someone in your firm who is knowledgeable about such matters, or you may seek the advice of the AICPA (ethics@aicpa.org). If your firm performs audits and other attest services for SEC registrants, you should also familiarize yourself with rules promulgated by the SEC and the PCAOB.
The staff of the AICPA Professional Ethics Division prepared a plain-English digest of the AICPA independence rules to help you to understand independence requirements under the AICPA Code of Professional Conduct and, if applicable, other rule-making and standard-setting bodies. This digest of the AICPA independence rules is available on the AICPA Professional Ethics Division’s website at www.aicpa.org/interestareas/professionalethics/resources/tools/downloadedocuments/plain%20english%20guide.pdf.

**Covered Member**

.10

Know when you meet the definition of a covered member. Whenever you are a *covered member* with respect to a particular attest client, you become subject to the highest possible level of independence restrictions (for example, restrictions on financial and business interests, and your family's employment). According to paragraph .12 of ET section 0.400, you are a *covered member* with respect to a client if you are

- an individual on the attest engagement team;
- an individual in a position to influence the attest engagement;
- a partner, partner equivalent (as defined in paragraph .38 of ET section 0.400), or manager who provides more than 10 hours of nonattest services to the attest client;
- a partner or partner equivalent in the office in which the lead attest engagement partner primarily practices in connection with the attest engagement;
- the firm, including the firm's employee benefit plans; or
- an entity whose operating, financial, or accounting policies can be controlled (as defined by generally accepted accounting principles [GAAP] for consolidation purposes) by any of the individuals or entities described in the preceding items or by two or more such individuals or entities if they act together.

.11

However, due to their magnitude, two relationships with a client impair independence even when you are *not* a covered member. The following rules apply to partners and professional employees of a firm who are not covered members:

- No partner or professional employee may be simultaneously associated with an attest client during the period covered by the financial statements or during the period of the professional engagement as a
director, officer, or employee (or in any capacity equivalent to a member of management),

— promoter, underwriter, or voting trustee, or

— trustee of any of the client's employee benefit plans.

• No partner or professional employee, his or her immediate family, or any group of such persons acting together may own more than 5 percent of an attest client's outstanding equity securities (or other ownership interests).

Networks and Network Firms

.12

According to the “Networks and Network Firms” interpretation, a network firm is required to be independent of financial statement audit and review clients of the other network firms if the use of the audit or review report by the client is not restricted, as defined by professional standards. For all other attest clients, consideration should be given to any threats the firm knows or has reason to believe may be created by network firm interests and relationships. If those threats are not at an acceptable level, safeguards should be applied to eliminate the threats or reduce them to an acceptable level.

.13

To enhance capabilities to provide professional services, CPA firms may join larger groups, which typically are membership associations that are separate legal entities that are otherwise unrelated to their members. The associations facilitate their members’ use of association services and resources; however, the associations themselves do not typically engage in the practice of public accounting or provide professional services to their members’ clients or to other third parties. Firms and other entities in the association cooperate with the firms and other entities that are members of the association, thereby enhancing their capabilities to provide professional services. For example, a firm may become a member of an association in order to refer work to, or receive referrals from, other association members. According to the “Networks and Network Firms” interpretation, that characteristic alone would not be sufficient for the association to constitute a network or for the firm to be considered a network firm.

.14

However, an association would be considered a network (and its members network firms) under the “Networks and Network Firms” interpretation if, in addition to cooperation among member firms for the purpose of enhancing their capabilities to provide professional services, one or more of the following additional characteristics of a network are present:
• The use of a common brand name (including common initials) as part of the firm name

• Common control (as defined by generally accepted accounting principles in the United States of America) among the firms through ownership, management, or other means

• Profits or costs, excluding costs of operating the association; costs of developing audit methodologies, manuals, and training courses; and other costs that are immaterial to the firm

• Common business strategy that involves ongoing collaboration amongst the firms whereby the firms are responsible for implementing the association's strategy and are held accountable for performance pursuant to that strategy

• Significant part of professional resources

• Common quality control policies and procedures that firms are required to implement and that are monitored by the association

.15

When a firm participates in such an association and one or more of the preceding characteristics are present, the firm is considered a network firm. Any entity that the firm controls by itself or through one or more of its owners is also considered a network firm. In addition, any entity that can control the firm or that the firm is under common control with would also be considered a network firm.

.16

It is possible that not all firms in the association will meet one of the preceding characteristics. In such situations, only the subset of firms that meet one or more of the characteristics would be considered network firms.

.17

The independence requirements apply to any entity within the network that meets the definition of a network firm.

.18

The staff of the AICPA Professional Ethics Division prepared nonauthoritative network firm implementation guidance and nonauthoritative frequently asked questions and case studies for network firms to assist practitioners to understand and implement the “Networks and Network Firms” interpretation. This nonauthoritative guidance can be found at www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/Pages/default.aspx.
Family Members

.19

The investments and employment of certain family members may impair your independence. Know which of your family members meet the definition of immediate family, as defined in paragraph .19 of ET section 0.400, and which ones meet the definition of close relative as defined in paragraph .08 of ET section 0.400.

.20

If you are a covered member with respect to a client, members of your immediate family (your spouse, spousal equivalent, or dependents [whether related or not]) should follow the same rules as you. So, for example, your spouse's investments should be investments that you could own under the rules. This would be the case even if your spouse keeps the investments in his or her own name or with a different broker. In addition, when materiality is a factor, the covered member’s and immediate family member’s financial interest are combined.

.21

The following are exceptions to this general rule:

a. Your immediate family member's employment with a client would not impair your firm's independence provided he or she is not in a key position, as defined in paragraph .27 of ET section 0.400. A key position is one in which your immediate family member

i. has primary responsibility for significant accounting functions that support material components of the financial statements;

ii. has primary responsibility for preparing the financial statements; or

iii. has the ability to exercise influence over the contents of the financial statements, including when the individual is a member of the board of directors or similar governing body, CEO, president, CFO, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, or any equivalent position.

b. Immediate family members in permitted employment positions may participate in certain employee benefit plans (other than certain share-based arrangements or nonqualified deferred compensation plans) that are attest clients or are sponsored by an attest client, provided the plan is offered to all employees in comparable positions and the immediate family member does not serve in a position of governance for the plan or have the ability to supervise or participate in the plan’s investment decisions or selection of investment options.

c. Immediate family members of certain covered members may invest in an attest client through employee benefit plans that aren’t considered share-based compensation arrangements, as defined in paragraph .44 of ET section 0.400, or nonqualified deferred compensation arrangements
(for example, retirement or savings account), provided the immediate family member has no other investment options available for selection, and when such option becomes available, the immediate family member selects the option and disposes of any direct or material indirect financial interest in the attest client.

d. Immediate family members in permitted employment positions of certain covered members may participate in share-based compensation arrangements and nonqualified deferred compensation plans provided certain safeguards are implemented.

e. The covered members whose families may invest or participate in the plans described in preceding items c and d are the following:

i. Partners and managers who provide only nonattest services to the attest client.

ii. Partners or partner equivalents who are covered members only because they practice in the same office where the client's lead attest partner practices in connection with the engagement.

.22

Also note that at no time may any direct or material indirect financial interests in an attest client permitted by the preceding exceptions exceed 5 percent of the attest client’s outstanding equity securities or other ownership interests.

.23

The close relatives of most covered members will be subject to some employment and financial restrictions. These covered members are

- persons on the attest engagement team,
- persons who can influence the attest engagement, and
- any partners in the office where the client's lead partner on the attest engagement practices.

.24

Close relatives are your

- nondependent children,
- siblings, or
• parents.

Therefore, as a covered member, your close relative's employment by a client would impair independence if your relative held a key position with the client. However, if you are a covered member who provides only nonattest services to a client, then your close relative’s employment by a client in a key position would not impair independence.

Rules pertaining to your close relative’s financial interests differ depending on why you are considered a covered member:

• If you are a covered member because you participate on the client's attest engagement team, your independence would be considered to be impaired if you are aware that your close relative has a financial interest in the client that either
  — was material to your relative's net worth or
  — enables the relative to exercise significant influence over the attest client.

• If you are a covered member because you are able to influence the client's attest engagement or are a partner or partner equivalent in the office in which the lead attest engagement partner practices in connection with the engagement, your independence will be impaired if you are aware that your close relative has a financial interest in the client that
  — is material to your relative's net worth and
  — enables your relative to exercise significant influence over the attest client.

Financial Relationships

There are various types of financial interests and some of those interests affect independence. Although your firm and its employee benefit plans are also subject to the financial interest provisions of the independence rules (firms are included in the definition of covered member), here we focus on their application to individuals.
As a covered member with respect to a particular client, you (and your spouse, or equivalent, and dependents) may not have a

- direct financial interest in an attest client, regardless of how immaterial it would be to your net worth.
- material indirect financial interest in an attest client.

*Note:* The AICPA Code of Professional Conduct does not define or otherwise provide guidance on determining materiality. In determining materiality, you should apply professional judgment to all relevant facts and circumstances and refer to applicable guidance in the professional literature. Both qualitative and quantitative factors should be considered.

.29

In addition, if you commit to acquire a financial interest in a client with respect to which you are a covered member, your independence would be impaired. For example, if you sign a stock subscription agreement with the client, your independence would be considered impaired as soon as you sign the agreement.

.30

A financial interest is defined in paragraph .15 of ET section 0.400 as an ownership interest in an equity or a debt security issued by an entity, including rights and obligations to acquire such an interest and derivatives directly related to such interest.

.31

Examples of financial interests include shares of stock, mutual fund shares, debt security issued by an entity, partnership units, stock rights, options, or warrants to acquire an interest in an attest client; or rights of participation, such as puts, calls, or straddles.

.32

As defined in paragraph .13 of ET section 0.400, direct financial interests are financial interests that are

- owned by you directly;
- under your control; or
- beneficially owned [fn.1] by you through an investment vehicle, estate, trust, or other intermediary if you can either
control the intermediary, or

— have the authority to supervise or participate in the intermediary's investment decisions.

For example, if you invest in a participant directed 401(k) plan, whereby you are able to select the investments held in your account or are able to select from investment alternatives offered by the plan, you would be considered to have a direct financial interest in the investments held in your account.

You also have a direct financial interest in an attest client when you have a financial interest in an attest client through one of the following:

- A partnership, if you are a general partner.
- A Section 529 savings plan, if you are the account owner.
- An estate, if you serve as an executor and meet certain other criteria.
- A trust, if you serve as the trustee and meet certain other criteria.

Indirect financial interests, as defined in paragraph .22 of ET section 0.400, arise if you have a financial interest that is beneficially owned through an investment vehicle, estate, trust, or other intermediary when you can neither control the intermediary nor have the authority to supervise or participate in the intermediary’s investment decisions. For example, if you invest in a defined contribution plan that is not participant directed and you have no authority to supervise or participate in the plan’s investment decisions, you would be considered to have an indirect financial interest in the underlying plan investments, in addition to a direct financial interest in the plan.

Extensive examples of various types of financial interests and whether they should be considered as direct or indirect financial interests, including investments in mutual funds, compensation, retirement and savings plans, Section 529 plans, trusts, partnerships, limited liability companies, and insurance products, can be found in the interpretations in the “Financial Interests” subtopic of the “Independence Rule.”

**Employment or Association With Client**
As a partner or professional employee of your firm, independence would be considered to be impaired if you entered into certain business relationships with an attest client of the firm. Accordingly, you may not serve an attest client as any of the following:

- Director, officer, employee, or in any management capacity
- Promoter, underwriter, or voting trustee
- Stock transfer or escrow agent
- General counsel (or equivalent)
- Trustee for an attest client's pension or profit-sharing trust

In essence, any time you are able to make management decisions on behalf of an attest client or exercise authority over an attest client's operations or business affairs, independence is considered impaired.

Your independence is considered impaired even if you were a volunteer board member because you would be part of the attest client's governing body and therefore would be able to participate in the client's management decisions.

If you are an honorary director or trustee for an attest client that is a not-for-profit charitable, civic, or religious organization, you will not be considered employed by or associated with the attest client. For this to occur,

a. your position is purely honorary.
b. you may not vote or participate in managing the organization.
c. your position is clearly identified as honorary in any internal or external correspondence.
In addition, if you serve on a client's advisory board, you will not be considered employed by or associated with the attest client provided

- the advisory board's function is purely advisory.
- the advisory board does not appear to make decisions for the attest client.
- the advisory board and any decision making boards are separate and distinct bodies.
- common membership between the advisory board and any decision making groups is minimal.

**Key Point**

Before accepting an invitation to serve on a client’s advisory board, a covered member may ask to review the advisory board’s governing document to verify that the advisory board’s function is indeed purely advisory and that the advisory board indeed does not make decisions for the client.

**Serving as an Adjunct Faculty Member of an Educational Institution That Is Also an Attest Client**

41

A partner or professional employee of a CPA firm may serve as an adjunct faculty member of an educational institution (for example, college or university) that is also an attest client of the CPA firm, if all of the following criteria are met:

- The position is part-time and nontenured.
- The partner or professional employee does not assume any management responsibilities or set policies for the education institution.
- The partner or professional employee does not participate in any employee benefit plans offered by the educational institution, unless participation is required by the plan.
- The partner or professional employee is not in a *key position* (as defined in paragraph .27 of ET section 0.400) at the education institution.
- The partner or professional employee does not participate on the education institution’s attest engagement team and cannot influence that attest engagement.
When the relationship is terminated, in order for independence to be maintained, the member would need to comply with the requirements of the "Former Employment or Association With an Attest Client” interpretation under the “Independence Rule.”

Unpaid Fees

.43

If a client of the member’s firm has not paid fees for previously rendered professional services, then independence is considered to be impaired if, when the report on the client’s current year is issued, billed or unbilled fees, or a note receivable arising from such fees, remain unpaid for any professional services provided more than one year prior to the date of the report.

Affiliates

The following guidance (paragraphs .44–.47) is from the “Client Affiliates” interpretation.

.44

Members are required to be independent of certain affiliates of a financial statement attest client (defined as audits and reviews of financial statements and compilations of financial statements when the member’s compilation report does not disclose a lack of independence).

.45

The following entities should be considered affiliates of a financial statement attest client:

- An entity (for example, subsidiary, partnership, or limited liability company [LLC]) that a financial statement attest client can control.

- An entity in which a financial statement attest client, or an entity controlled by the financial statement attest client, has a direct financial interest that gives the financial statement attest client significant influence over such entity and that is material to the financial statement attest client.

- An entity (for example, parent, partnership, or LLC) that controls a financial statement attest client when the financial statement attest client is material to such entity.

- An entity with a direct financial interest in the financial statement attest client when that entity has significant influence over the financial statement attest client, and the interest in the financial statement attest client is material to such entity.
• A sister entity of a financial statement attest client, if the financial statement attest client and sister entity are each material to the entity that controls both.

• A trustee that is deemed to control a trust financial statement attest client that is not an investment company.

• The sponsor of a single-employer employee benefit plan financial statement attest client.

• Any union or participating employer that has significant influence over a multiple or multiemployer employee benefit plan financial statement attest client.

• An employee benefit plan sponsored by either a financial statement attest client or an entity controlled by the financial statement attest client. A financial statement attest client that sponsors an employee benefit plan includes, but is not limited to, a union whose members participate in the plan and participating employers of a multiple or multiemployer plan.

• An investment adviser, general partner, or trustee of an investment company financial statement attest client (fund), if the fund is material to the investment adviser general partner or trustee, and they are deemed to have either control or significant influence over the fund. When considering materiality, members should consider investments in, and fees received from, the fund.

With respect to the preceding subparagraphs, the term control(s)(led) is as used in FASB ASC 810, for commercial entities and FASB ASC 958-805-20 for not-for-profit entities. The term significant influence is as used in FASB ASC 323-10-15.

.46

Members should apply the independence provisions of the AICPA Code of Professional Conduct to the affiliates of their financial statement attest clients, except in the following situations:

a. A covered member may have a loan to or from an individual who is an officer, a director, or a 10 percent or more owner of an affiliate of a financial statement attest client unless the covered member knows or has reason to believe that the individual is in such a position with such an affiliate. If the covered member knows or has reason to believe that the individual is an officer, a director, or a 10 percent or more owner of such an affiliate, the covered member should evaluate the effect that the relationship would have on the member’s independence by applying the “Conceptual Framework for Independence” interpretation.

b. A member or his or her firm may provide prohibited nonattest services to entities described under subparagraphs c–j of the definition of affiliate provided that it is reasonable to conclude that the services do not create a self-review threat with respect to the financial statement attest client because the results of the nonattest services will not be subject to financial statement attest procedures. For any other threats that are created by the provision of the nonattest services that are not at an acceptable level (in particular, those relating to management participation), such threats should be eliminated or reduced to an acceptable level by the application of safeguards.
c. A firm will only have to apply the “Subsequent Employment or Association With an Attest Client” interpretation if the former employee, by virtue of his or her employment at an entity described in the definition of affiliate would put the employee in a key position with respect to the financial statement attest client. Individuals in a position to influence the attest engagement and on the attest engagement team who are considering employment with an affiliate of a financial statement attest client will still need to report consideration of employment to an appropriate person in the firm and remove themselves from the financial statement attest engagement, even if the position with the affiliate is not a key position.

d. Immediate family members and close relatives of a covered member may be employed at an entity described in the definition of affiliate in a key position, provided that the position does not put them in a key position with respect to the financial statement attest client.

.47

A member must expend best efforts to obtain the information necessary to identify a financial statement attest client’s affiliates. If, after expending best efforts, a member is unable to obtain the information to determine which entities are affiliates of a financial statement attest client, the member is required to

a. discuss the matter, including the potential impact on independence, with those charged with governance;

b. document the results of that discussion with those charged with governance and the efforts taken to obtain the information to identify the affiliates of the financial statement attest client; and

c. obtain written assurance from the financial statement attest client that it is unable to provide the member with the information necessary to identify the client’s affiliates.

.48

Entities that are deemed to be affiliates of financial statement attest clients are restricted entities. Paragraphs .49–.51 provide additional discussion on restricted entities.

Restricted Entities

.49

Be familiar with the firm's restricted entities. Restricted entities are those entities for whom the firm provides attest services and any affiliates (see paragraphs .44–.48). Many firms maintain a formal list or database of these entities. If yours is one of these firms, you should know how to access the list.
Maintain the integrity of the restricted entity list. If you perform attest services, then you need to make sure that those clients, along with any affiliates, are identified as restricted entities of the firm.

Consult the restricted entities list regularly. Get into the habit of referring to the firm's restricted entity list whenever you are considering changes in circumstances that could affect your independence. For example, you may consult the restricted entity list prior to

- making an investment or acquiring a financial interest in an entity.
- entering into a business relationship.
- obtaining a loan or refinancing an existing loan.
- having an immediate family member change employers or assume new responsibilities at an existing job.

Nonattest Services

Be aware of the rules relating to the performance of nonattest services. If you provide nonattest services to restricted entities, you should be familiar with the interpretations under the “Nonattest Services” subtopic of the “Independence Rule” that establishes standards and provides guidance regarding the performance of nonattest services. The interpretations in this subtopic discuss the services that are permitted and prohibited under the ruling, as well as the member's responsibilities for establishing an understanding of the engagement with your client and documenting various aspects of the engagement. If your clients are SEC registrants, you should be aware of the more restrictive SEC rules in this area. Certain other regulators (for example, the GAO) may have more restrictive rules concerning nonattest services, which should be reviewed depending upon the circumstances of the engagement.

The term nonattest services includes accounting and consulting services that are not part of an attest engagement; whereas the Code of Professional Conduct defines an attest engagement as one that requires independence under professional standards; for example, audits and reviews of financial statements or agreed upon procedures performed under the attestation standards. Nonattest services specifically addressed in the rules are as follows:
- Advisory services
- Bookkeeping, payroll, and other disbursement services (including financial statement preparation, cash-to-accrual conversions, and reconciliations)
- Internal audit services
- Benefit plan administration services
- Investment advisory or management services
- Tax services
- Corporate finance consulting services
- Appraisal, valuation, or actuarial services
- Executive or employee recruiting services
- Business risk consulting services
- Information systems design, installation, or integration services
- Forensic accounting

A practitioner is allowed to prepare and maintain monthly account reconciliations for an attest client provided the client accepts responsibility for the services and the other general requirements of the “Nonattest Services” interpretations are met, such as ensuring that the client reviews and approves the account reconciliations and sufficiently understands the services performed to oversee them.

.54

The “General Requirements for Performing Nonattest Services” interpretation lists three general requirements in order to maintain independence when performing permitted nonattest services. Consideration should also be given to the requirements in the “Cumulative Effect on Independence When Providing Multiple Nonattest Services” interpretation.

.55

The first general requirement is that before performing nonattest services, the member should determine that the client has agreed to
• assume all management responsibilities.

• oversee the service, by designating an individual, preferably within senior management who possesses suitable skill, knowledge, and/or experience. The member should assess and be satisfied that such individual understands the services to be performed sufficiently to oversee them. However, the individual is not required to possess the expertise to perform or reperform the services.

• evaluate the adequacy and results of the services performed.

• accept responsibility for the results of the services.

To avoid assuming management responsibilities when providing nonattest services to the client, the member should be satisfied that management will be able to meet all these criteria, make an informed judgment on the results of the member's nonattest services, and be responsible for making the significant judgments and decisions that are the proper responsibility of management. In cases in which the client is unable or unwilling to assume these responsibilities (for example, the client cannot oversee the nonattest services provided or is unwilling to carry out such responsibilities due to lack of time or desire), the member's provision of these services would impair independence. A practitioner should also consider whether the performance of multiple (otherwise permitted) nonattest services in the aggregate would create a significant threat to independence and, if so, to determine what, if any, safeguards could be applied to eliminate or reduce the threat to an acceptable level. When no safeguards are available to eliminate or reduce the threats to an acceptable level, independence would be considered impaired.

.56

The second of the three general requirements found in the “General Requirements for Performing Nonattest Services” interpretation states that a member should not assume management responsibilities for the attest client. (However, the member may provide advice, research materials, and recommendations to assist the client's management in performing its functions and making decisions.)

.57

The third general requirement is that before performing nonattest services, the member should establish and document in writing his or her understanding with the client (for example, the board of directors, audit committee, or management, as appropriate in the circumstances) regarding the following:

• Objectives of the engagement

• Services to be performed

• Client's acceptance of its responsibilities
• Member's responsibilities

• Any limitations of the engagement

The understanding might be documented in a separate engagement letter, in the working papers, or in an internal memo, or it might be included in an engagement letter obtained in conjunction with an attest engagement.

.58

The first and third general requirements do not apply to certain routine activities performed by the member, such as, assisting clients with technical accounting questions, advising on internal controls, or providing periodic training on new pronouncements that are part of the normal client-member relationship.

.59

In addition, the following are examples of the types of activities that impair independence:

• Setting policies or strategic direction for the attest client

• Directing or accepting responsibility for the actions of the attest client's employees except to the extent permitted when using internal auditors to provide assistance for services performed under auditing or attestation standards

• Authorizing, executing, or consummating a transaction, or otherwise exercising authority on behalf of an attest client or having the authority to do so

• Preparing source documents, in electronic or other form, evidencing the occurrence of a transaction

• Having custody of attest client assets

• Deciding which recommendations of the member or other third parties to implement or prioritize

• Reporting to those in charge of governance on behalf of management

• Accepting responsibility for the management of an attest client's project

• Accepting responsibility for the preparation and fair presentation of the attest client's financial statements in accordance with the applicable financial reporting framework
• Accepting responsibility for designing, implementing, or maintaining internal control

• Performing ongoing evaluations of the attest client's internal control as part of its monitoring activities

.60

Additionally, the “Nonattest Services” interpretation requires you comply with more restrictive independence provisions, if applicable, of certain regulators such as state boards of accountancy, the SEC, and the GAO.

.61

*Report any apparent violations.* If you become aware of any apparent violations of the independence rules, you should report these immediately to the person in your firm responsible for independence matters.

.62

The procedures employed at the engagement level should be designed to ascertain whether the firm and its partners and employees have complied with all applicable independence rules. Overall firm requirements for independence are addressed in QC section 10. Refer to section 10,000, “Quality Control,” of this manual for additional discussion of QC section 10 and establishing and maintaining a firm’s system of quality control.

**Independence Quality Controls**

.63

Paragraph .22 of QC section 10, as further discussed in section 10,000 of this manual, states that the firm should establish policies and procedures designed to provide it with reasonable assurance that the firm, its personnel, and, when applicable, others subject to independence requirements (including network firm personnel), maintain independence when required by relevant ethical requirements. Such policies and procedures should enable the firm to

• communicate its independence requirements to its personnel and, when applicable, others subject to them.

• identify and evaluate circumstances and relationships that create threats to independence and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safe guards, or, if considered appropriate (that is, effective safeguards cannot be applied), withdraw from the engagement when withdrawal is possible under applicable law or regulation.
Such policies and procedures should require

- engagement partners to provide the firm with relevant information about client engagements, including the scope of services, to enable the firm to evaluate the overall effect, if any, on independence requirements.

- personnel to promptly notify the firm of circumstances and relationships that create a threat to independence so that appropriate action can be taken.

- the accumulation and communication of relevant information to appropriate personnel so that
  - the firm and its personnel can readily determine whether they satisfy independence requirements;
  - the firm can maintain and update information relating to independence; and
  - the firm can take appropriate action regarding identified threats to independence that are not at an acceptable level.

The firm should establish policies and procedures designed to provide it with reasonable assurance that it is notified of breaches of independence requirements and to enable it to take appropriate actions to resolve such situations. The policies and procedures should include requirements for

- personnel to promptly notify the firm of independence breaches of which they become aware.

- the firm to promptly communicate identified breaches of these policies and procedures to
  - the engagement partner who, with the firm, needs to address the breach; and
  - other relevant personnel in the firm and, when appropriate, the network and those subject to the independence requirements who need to take appropriate action.

- prompt communication to the firm, if necessary, by the engagement partner and the other individuals referred to in item b(ii) of the actions taken to resolve the matter so that the firm can determine whether it should take further action.
At least annually, the firm should obtain written confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent by the requirements set forth in the “Independence Rule” and its related interpretations of the AICPA Code of Professional Conduct and the rules of state boards of accountancy and applicable regulatory agencies.

67

The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements.

Additional Guidance

68

It is recommended that the auditor document all procedures discussed in this section in his or her working papers.

69

International independence standards are established by the International Federation of Accountants’ (IFAC) International Ethics Standards Board for Accountants and can be found in section 290, Independence—Audit and Review Engagements, and section 291, Independence—Other Assurance Engagements, of the IFAC’s Code of Professional Ethics for Professional Accountants. The IFAC’s Code of Professional Ethics for Professional Accountants can be found at http://web.ifac.org/publications/international-ethics-standards-board-for-accountants/code-of-ethics.

70

For additional guidance practitioners may refer to the AICPA Audit Risk Alert Independence and Ethics Developments—2014/15 (product nos. ARAIET14P [print] and ARAIET14E [eBook] and reproduced in section 8240). This annual alert informs you of recent developments in the area of independence and ethics for members, including developments in international independence standards discussed previously in paragraph .69. Moreover, the alert helps you understand your independence requirements under the AICPA Code and, if applicable, certain other rule making and standard setting bodies. Also, the alert contains the AICPA Plain English Guide to Independence, which discusses the independence rules of the principal standard setting bodies in plain, straightforward English so you can understand and apply them with greater confidence and ease.

Footnotes (AAM Section 3115 — Independence):
fn 1 As defined in paragraph .06 of ET section 0.400, a financial interest is beneficially owned whether or not the individual or entity is the record owner of the interest but has a right to some or all of the underlying benefits of ownership. These benefits include the authority to direct the voting or disposition of the interest or to receive the economic benefits of the ownership of the interest.

fn 2 The staff of the AICPA Professional Ethics Division issued nonauthoritative guidance in the form of a frequently asked question (FAQ) regarding performance of nonattest services. The FAQ document is available on the AICPA Professional Ethics Division’s website at www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/NonattestServicesFAQs.doc.
AAM Section 3120

Obtaining an Understanding of the Entity and Its Environment

This section contains the following references from AICPA Professional Standards:

- AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*
- AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*
- AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*
- AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- AU-C section 320, *Materiality in Planning and Performing and Audit*
- AU-C section 550, *Related Parties*

**General**

**.01**

AU-C section 315 establishes requirements and provides guidance regarding the auditor’s responsibility to identify and assess the risks of material misstatement in the financial statements through understanding the entity and its environment, including the entity’s internal control.

**.02**

The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels through understanding the entity and its environment, including the entity’s internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

**.03**

Audit procedures performed to obtain an understanding of the entity and its environment, including its internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels are referred to as *risk*.
assessment procedures.

.04

Risk assessment procedures are designed to gather and evaluate information about the client and are not specifically designed as substantive procedures or as tests of controls. Nevertheless, in performing risk assessment procedures, the auditor may obtain evidence about relevant assertions or the effectiveness of controls.

Auditor Requirements

Risk Assessment Procedures and Related Activities

.05

The auditor should perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and relevant assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion.

.06

Obtaining an understanding of the entity and its environment, including the entity’s internal control (referred to hereafter as an understanding of the entity), is a continuous, dynamic process of gathering, updating, and analyzing information throughout the audit. The understanding of the entity establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit when, for example

- assessing risks of material misstatement of the financial statements;
- determining materiality in accordance with AU-C section 320;
- considering the appropriateness of the selection and application of accounting policies and the adequacy of financial statement disclosures;
- identifying areas for which special audit consideration may be necessary (for example, related party transactions, the appropriateness of management’s use of the going concern assumption, considering the business purpose of transactions, or the existence of complex and unusual transactions);
• developing expectations for use when performing analytical procedures;

• responding to the assessed risks of material misstatement, including designing and performing further audit procedures to obtain sufficient appropriate audit evidence; and

• evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and management’s oral and written representations.

.07

Information obtained by performing risk assessment procedures and related activities may be used by the auditor as audit evidence to support assessments of the risks of material misstatement. In addition, the auditor may obtain audit evidence about classes of transactions, account balances, or disclosures and relevant assertions and about the operating effectiveness of controls, even though such procedures were not specifically planned as substantive procedures or tests of controls. The auditor also may choose to perform substantive procedures or tests of controls concurrently with risk assessment procedures because it is efficient to do so.

.08

The auditor is required to exercise professional judgment to determine the extent of the required understanding of the entity. The auditor’s primary consideration is whether the understanding of the entity that has been obtained is sufficient to meet the objective stated in AU-C section 315. The depth of the overall understanding that is required by the auditor is less than that possessed by management in managing the entity.

.09

The risks to be assessed include both those due to fraud and those due to error, and both are covered by AU-C section 315. However, the significance of fraud is such that further requirements and guidance are included in AU-C section 240 regarding risk assessment procedures and related activities to obtain information that is used to identify the risks of material misstatement due to fraud. See further discussion in section 3145, "Fraud."

.10

Although the auditor is required to perform all the risk assessment procedures described in paragraph .06 of AU-C section 315 in the course of obtaining the required understanding of the entity promulgated in paragraphs .12–.25 of AU-C section 315, the auditor is not required to perform all of them for each aspect of that understanding. Other procedures may be performed when the information to be obtained therefrom may be helpful in identifying risks of material misstatement. Examples of such procedures include the following:
• Reviewing information obtained from external sources, such as trade and economic journals; reports by analysts, banks, or rating agencies; or regulatory or financial publications

• Making inquiries of the entity’s external legal counsel or valuation specialists whom the entity has used

.11

The auditor should consider whether information obtained from the auditor’s client acceptance or continuance process is relevant to identifying risks of material misstatement.

.12

If the engagement partner has performed other engagements for the entity, the engagement partner should consider whether information obtained is relevant to identifying risks of material misstatement.

.13

During planning, the auditor should consider the results of the assessment of the risk of material misstatement due to fraud along with other information gathered in the process of identifying the risks of material misstatements.

.14

The risk assessment procedures should include the following:

a. Inquiries of management and others within the entity who, in the auditor’s professional judgment, may have information that is likely to assist in identifying risks of material misstatement due to fraud or error

b. Analytical procedures

c. Observation and inspection

.15

Paragraphs .A7–.A10 of AU-C section 315 (discussed in section 3155, "Analytical Procedures") provides guidance on analytical procedures performed as risk assessment procedures.
Inquiries of Management and Others Within the Entity

Much of the information obtained by the auditor’s inquiries is obtained from management and those responsible for financial reporting. However, the auditor also may obtain information or a different perspective in identifying risks of material misstatement through inquiries of others within the entity and other employees with different levels of authority. For example

- inquiries directed toward those charged with governance may help the auditor understand the environment in which the financial statements are prepared.
- inquiries directed toward internal audit personnel may provide information about internal audit procedures performed during the year relating to the design and effectiveness of the entity’s internal control and whether management has satisfactorily responded to findings from those procedures.
- inquiries of employees involved in initiating, authorizing, processing, or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies.
- inquiries directed toward in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements (such as joint ventures) with business partners, and the meaning of contract terms.
- inquiries directed toward marketing or sales personnel may provide information about changes in the entity’s marketing strategies, sales trends, or contractual arrangements with its customers.

Examples of Inquiries of Others Within the Entity

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<tr>
<th>Inquiries of these individuals (outside of management or the financial reporting process, or both)</th>
<th>May help the auditor understand</th>
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</table>
| Those charged with governance | • the environment in which the financial statements are prepared.  
• whether they have knowledge of any fraud or suspected fraud. |
- how they exercise oversight of the entity's programs and controls that address fraud.

- their views on where the company is most vulnerable to fraud.

- how financial statements are used.

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<th>Internal audit personnel</th>
<th>the design and operating effectiveness of internal control.</th>
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<td>internal audit activities related to internal control over financial reporting.</td>
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<td>whether management has responded satisfactorily to internal audit findings.</td>
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<td></td>
<td>their views on where the company is most vulnerable to fraud.</td>
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<tr>
<th>Employees involved in the initiation, processing, or recording of complex or unusual transactions</th>
<th>the controls over the selection and application of accounting policies related to those transactions.</th>
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<td>the business rationale for those transactions.</td>
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<th>IT systems users</th>
<th>how IT users identify changes to IT systems and how frequently those changes occur.</th>
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<td>how users &quot;work around&quot; IT systems for those circumstances where the IT system does not support them.</td>
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| In-house legal counsel | • litigation.  
|                       | • compliance with laws and regulations.  
|                       | • fraud or suspected fraud.  
|                       | • warranties.  
|                       | • post-sales obligations.  
|                       | • arrangements such as joint ventures.  
|                       | • the meaning of certain contract terms.  
| Marketing, sales, or production personnel | • marketing strategies.  
|                       | • sales trends.  
|                       | • production strategies.  
|                       | • contractual arrangements with customers.  
|                       | • any pressures to meet budgets or change reported performance measures.  |
Analytical Procedures

.18

Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Analytical procedures performed as risk assessment procedures may include both financial and nonfinancial information (for example, the relationship between sales and square footage of selling space or volume of goods sold).

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Analytical procedures may enhance the auditor’s understanding of the client’s business and the significant transactions and events that have occurred since the prior audit and also may help to identify the existence of unusual transactions or events and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

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However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures provide only a broad initial indication about whether a material misstatement may exist. Accordingly, in such cases, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures.

Considerations Specific to Smaller, Less Complex Entities

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Some smaller entities may not have interim or monthly financial information that can be used for purposes of analytical procedures. In these circumstances, although the auditor may be able to perform limited analytical procedures for purposes of planning the audit or obtain some information through inquiry, the auditor may need to plan to perform analytical procedures to identify and assess the risks of material misstatement when an early draft of the entity’s financial statements is available.
Observation and inspection may support inquiries of management and others and also may provide information about the entity and its environment. Examples of such audit procedures include observation or inspection of the following:

- The entity’s operations
- Documents (such as business plans and strategies), records, and internal control manuals
- Reports prepared by management (such as quarterly management reports and interim financial statements), those charged with governance (such as minutes of board of directors’ meetings), and internal audit
- The entity’s premises and plant facilities

Information Obtained in Prior Periods

When the auditor intends to use information obtained from the auditor’s previous experience with the entity and from audit procedures performed in previous audits, the auditor should determine whether changes have occurred since the previous audit that may affect its relevance to the current audit.

The auditor’s previous experience with the entity and audit procedures performed in previous audits may provide the auditor with information about such matters as

- past misstatements and whether they were corrected on a timely basis.
- the nature of the entity and its environment and the entity’s internal control (including deficiencies in internal control).
- significant changes that the entity or its operations may have undergone since the prior financial period, which may assist the auditor in gaining a sufficient understanding of the entity to identify and assess risks of material misstatement.
Paragraph .10 of AU-C section 315 requires the auditor to determine whether information obtained in prior periods remains relevant if the auditor intends to use that information for the purposes of the current audit. For example, changes in the control environment may affect the relevance of information obtained in the prior year. To determine whether changes have occurred that may affect the relevance of such information, the auditor may make inquiries and perform other appropriate audit procedures, such as walk-throughs of relevant systems.

Discussion Among the Engagement Team

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The engagement partner and other key engagement team members should discuss the susceptibility of the entity’s financial statements to material misstatement and the application of the applicable financial reporting framework to the entity’s facts and circumstances. The engagement partner should determine which matters are to be communicated to engagement team members not involved in the discussion.

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The discussion among the engagement team about the susceptibility of the entity’s financial statements to material misstatement provides an opportunity for more experienced engagement team members, including the engagement partner, to share their insights based on their knowledge of the entity.

allows the engagement team members to exchange information about the business risks to which the entity is subject and about how and where the financial statements might be susceptible to material misstatement due to fraud or error.

assists the engagement team members to gain a better understanding of the potential for material misstatement of the financial statements in the specific areas assigned to them and to understand how the results of the audit procedures that they perform may affect other aspects of the audit, including the decisions about the nature, timing, and extent of further audit procedures.

provides a basis upon which engagement team members communicate and share new information obtained throughout the audit that may affect the assessment of risks of material misstatement or the audit procedures performed to address these risks.

This discussion may be held concurrently with the discussion among the engagement team that is required by paragraph .15 of AU-C section 240 to discuss the susceptibility of the entity’s financial statements to fraud. AU-C section 240 further addresses the discussion among the engagement team about the risks of fraud.
It is not always necessary or practical for the discussion to include all members in a single discussion (as in group audits), nor is it necessary for all the members of the engagement team to be informed of all the decisions reached in the discussion. The engagement partner may discuss matters with key members of the engagement team, including, if considered appropriate, those with specific skills or knowledge, and those responsible for the audits of components, while delegating discussion with others, taking account of the extent of communication considered necessary throughout the engagement team. A communications plan, agreed by the engagement partner, may be useful.

Topics for audit team discussion may include the following:

- Areas of significant audit risk
- Unusual accounting procedures used by the client
- Important control systems
- Significant IT applications and how the client's use of IT may affect the audit
- Areas susceptible to management override of controls
- Materiality at the financial level and at the account level and tolerable misstatement
- How materiality will be used to determine the extent of testing
- The application of generally accepted accounting principles to the client's facts and circumstances and in light of the entity's accounting policies
- The need to
  — exercise professional skepticism throughout the engagement
  — remain alert for information or other conditions that indicate that a material misstatement due to fraud or error may have occurred
  — follow up rigorously on any indications of a material misstatement
Considerations specific to smaller, less complex entities. Many small audits are carried out entirely by the engagement partner (who may be a sole practitioner). In such situations, it is the engagement partner who, having personally conducted the planning of the audit, would be responsible for considering the susceptibility of the entity’s financial statements to material misstatement due to fraud or error.

Understanding the Entity and Its Environment, Including the Entity’s Internal Control

Note: Appendix A, "Understanding the Entity and Its Environment," in AU-C section 315 contains examples of matters that the auditor may consider in obtaining an understanding of the entity and its environment.

The Entity and Its Environment

The auditor should obtain an understanding of the following:

- Relevant industry, regulatory, and other external factors, including the applicable financial reporting framework
- The nature of the entity, including
  - its operations;
  - its ownership and governance structures;
  - the types of investments that the entity is making and plans to make, including investments in entities formed to accomplish specific objectives; and
  - the way that the entity is structured and how it is financed,
    to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.
- The entity’s selection and application of accounting policies, including the reasons for changes thereto. The auditor should evaluate whether the entity’s accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.
- The entity’s objectives and strategies and those related business risks that may result in risks of material misstatement.
The measurement and review of the entity's financial performance.

Industry, Regulatory, and Other External Factors

Relevant industry factors include industry conditions, such as the competitive environment, supplier and customer relationships, and technological developments. Examples of matters the audit may consider include

- the market and competition, including demand, capacity, and price competition.
- cyclical or seasonal activity.
- product technology relating to the entity’s products.
- energy supply and cost.

The industry in which the entity operates may give rise to specific risks of material misstatement arising from the nature of the business, the degree of regulation. For example, long term contracts may involve significant estimates of revenues and expenses that give rise to risks of material misstatement. In such cases, it is important that the engagement team includes members with sufficient, relevant knowledge and experience, as required by AU-C section 220.

Relevant regulatory factors include the regulatory environment. The regulatory environment encompasses, among other matters, the applicable financial reporting framework and the legal and political environment. Examples of matters the auditor may consider include the following:

- Accounting principles and industry-specific practices
- Regulatory framework for a regulated industry
- Laws and regulations that significantly affect the entity’s operations, including direct supervisory activities
• Taxation (corporate and other)

• Government policies currently affecting the conduct of the entity’s business, such as monetary (including foreign exchange controls), fiscal, financial incentives (for example, government aid programs), and tariffs or trade restrictions policies

• Environmental requirements affecting the industry and the entity’s business

AU-C section 250 includes some specific requirements related to the legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates.

Examples of other external factors affecting the entity that the auditor may consider include the general economic conditions, interest rates and availability of financing, and inflation or currency revaluation.

Nature of the Entity

An understanding of the nature of an entity enables the auditor to understand such matters as

• whether the entity has a complex structure (for example, with subsidiaries or other components in multiple locations). Complex structures often introduce issues that may give rise to risks of material misstatement. Such issues may include whether goodwill, joint ventures, investments, or investments in entities formed to accomplish specific objectives are accounted for appropriately.

• the ownership and relations between owners and other people or entities. This understanding assists in determining whether related party transactions and balances have been identified and accounted for appropriately. AU-C section 550 addresses the auditor’s considerations relevant to related parties.

Examples of matters that the auditor may consider when obtaining an understanding of the nature of the entity include

• business operations such as
— the nature of revenue sources, products or services, and markets, including involvement in electronic commerce, such as Internet sales and marketing activities.

— the conduct of operations (for example, stages and methods of production or activities exposed to environmental risks).

— alliances, joint ventures, and outsourcing activities.

— geographic dispersion and industry segmentation.

— the location of production facilities, warehouses, and offices and the location and quantities of inventories.

— key customers and important suppliers of goods and services.

— employment arrangements (including the existence of union contracts, pension and other postemployment benefits, stock option or incentive bonus arrangements, and government regulation related to employment matters).

— research and development activities and expenditures.

— transactions with related parties.

  • investments and investment activities such as

— planned or recently executed acquisitions or divestitures.

— investments and dispositions of securities and loans.

— capital investment activities.

— investments in nonconsolidated entities, including partnerships, joint ventures, and investments in entities formed to accomplish specific objectives.

  • financing and financing activities such as

— major subsidiaries and associated entities, including consolidated and nonconsolidated structures.

— debt structure and related terms, including off balance sheet financing arrangements and leasing arrangements.

— beneficial owners (local and foreign and their business reputation and experience) and related parties.
— the use of derivative financial instruments.

— financial reporting such as

— accounting principles and industry-specific practices, including industry-specific significant categories (for example, loans and investments for banks or research and development for pharmaceuticals).

— revenue recognition practices.

— accounting for fair values.

— foreign currency assets, liabilities, and transactions.

— accounting for unusual or complex transactions, including those in controversial or emerging areas (for example, accounting for stock-based compensation).

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Significant changes in the entity from prior periods may give rise to, or change risks of, material misstatement.

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An entity may form an entity that is intended to accomplish a narrow and well-defined purpose (for example, a variable interest entity), such as to effect a lease or a securitization of financial assets or to carry out research and development activities. It may take the form of a corporation, trust, partnership, or unincorporated entity. The entity on behalf of which an entity has been created may often transfer assets to the latter (for example, as part of a derecognition transaction involving financial assets), obtain the right to use the latter’s assets, or perform services for the latter, and other parties may provide the funding to the latter.

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Financial reporting frameworks often specify detailed conditions that are deemed to amount to control or circumstances under which an entity should be considered for consolidation. The financial reporting frameworks also may specify different bases for recognition of income related to transactions with these entities. The interpretation of the requirements of such frameworks often involves a detailed knowledge of the relevant agreements involving an entity formed for a specific purpose.

The Entity’s Selection and Application of Accounting Policies
An understanding of the entity’s selection and application of accounting policies may encompass such matters as

- the methods the entity uses to account for significant and unusual transactions.
- the effect of significant accounting policies in controversial or emerging areas for which a lack of authoritative guidance or consensus exists.
- significant changes in the entity’s accounting policies and disclosures and the reasons for such changes.
- financial reporting standards, and laws and regulations that are new to the entity and when and how the entity will adopt such requirements.
- the financial reporting competencies of personnel involved in selecting and applying significant new or complex accounting standards.

**Accounting processing.** In obtaining an understanding of how a client processes accounting information—from the initiation of the transaction to its inclusion in the financial statements—the auditor may focus on how the computer is used to process data and the ways in which transactions are valued, classified, and summarized in data files, journals, or ledgers. For some transactions, there may be several significant processing activities and accounting records, including the use of computer programs. Other transactions may involve only limited processing activities performed manually.

**Practical example:** At Jones Grocery, sales are initiated by customers and recorded in the cash register. At the end of the day the cash register totals are reconciled to the cash on hand, and a deposit is prepared for the day’s receipts. On a weekly basis, the daily cash register tapes are batched for each store, forwarded to Mrs. Jones, and entered into the computer. The computer generates a sales register, a sales analysis report, and posts the sales totals to the general ledger. Also, the processing of inventory transactions (for example, receipt of goods, sales, and spoilage) involves several processing activities that are linked in the inventory module of the software package. On the other hand, recording depreciation expense is fairly simple. Fixed assets and the related depreciation are maintained on a computer spreadsheet, and each month, Mrs. Jones prepares a journal entry to record depreciation.

Understanding the accounting processing also involves understanding the information used for processing and when processing occurs. For example, when considering the completeness assertion, the auditor may obtain an understanding about whether transactions entered into the
The processing of accounting information may involve *end user computing*. End user computing occurs when the user is responsible for the development and execution of the computer application that generates the information used by that same person.

**Practical example:** *Mrs. Jones developed and maintains the fixed asset spreadsheet that serves as the source document for her monthly depreciation expense journal entry.*

In general, the product of end user computing may be used to

- process significant accounting information outside of the off the shelf accounting software package (for example, the fixed-asset spreadsheet is separate from the Jones Grocery general ledger software package);
- make significant accounting decisions (for example, a spreadsheet application may be used to generate information used to write down inventory); and
- accumulate footnote information (for example, a spreadsheet may be used to calculate the five-year debt maturity disclosure).

Generally, end users have no training in the formal computer application development process. Accordingly, applications developed by end users are often inadequately tested, and the development process is often not documented. This situation can cause significant difficulties for an organization if the end user computing application is critical to making business or financial decisions.

The access to end user computing applications may also be an audit concern. Many computer applications used in end user computing come with on-line systems that are capable of restricting users to specific applications, specific departments, or even specific fields. Often, however, these access restrictions facilities are not implemented.
To address these concerns and to ensure the end user applications process data completely and accurately, the auditor may look for control policies and procedures that

- require all significant end user applications to be adequately tested before use;
- prescribe documentation standards for significant end user applications;
- provide for adequate access controls to data;
- provide a mechanism to prevent or detect the use of incorrect versions of data files;
- provide for appropriate applications controls, for example, edit checks, range tests, or reasonableness checks; and
- support meaningful user reconciliations.

/accounting_records_supporting_information_and_specific_accounts.

In general, the auditor may identify the following for a client's significant accounts and transactions:

- Source documents
- Documents converted to computer media
- Computer files that are further processed in the flow of information to the general ledger and the financial statements
- Accounts (subsidiary or general ledger master files) affected by the transaction
- Relevant accounting reports, journals, and ledgers produced in the flow of information to the general ledger and the financial statements

A client's accounting systems may create many documents, files, and reports that are useful for managing the organization; however, not all will be relevant to the financial statements.

Practical example: At Jones Grocery, the sales analysis report is used for management information and analysis. The documents and reports relevant to the financial statements are the daily cash register tapes and the computer generated sales register.
Other significant events and conditions. The entity's information system may capture other events and conditions that are significant to the financial statements. This might involve, for example, nonrecurring or unusual transactions or adjustments and nonrecurring estimates.

Practical example: A broken water line, which is an uninsured risk, spoiled a large amount of produce and dry goods in one of the Jones Grocery stores. Based on a list of the lost inventory provided by the store manager, Mrs. Jones recorded a large spoilage loss.

Financial reporting process. When gaining an understanding of the financial reporting process, the auditor may determine the extent of client procedures to prepare accounting estimates (when significant accounting estimates are called for) and information for significant disclosures. The auditor may also understand the way in which general ledger information is summarized to determine how the amounts and disclosures are reported in the financial statements.

Objectives, Strategies, and Related Business Risks

The entity conducts its business in the context of industry, regulatory, and other internal and external factors. To respond to these factors, the entity’s management or those charged with governance define objectives, which are the overall plans for the entity. Strategies are the approaches by which management intends to achieve its objectives. The entity’s strategies and objectives may change over time.

Business risk is broader than the risk of material misstatement of the financial statements, though it includes the latter. Business risk may arise from change or complexity. A failure to recognize the need for change also may give rise to business risk. Business risk may arise, for example, from

- the development of new products or services that may fail;
- a market that, even if successfully developed, is inadequate to support a product or service; or
- flaws in a product or service that may result in liabilities and reputational risk.
An understanding of the business risks facing the entity increases the likelihood of identifying risks of material misstatement. This is because most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, the auditor does not have a responsibility to identify or assess all business risks because not all business risks give rise to risks of material misstatement.

Examples of matters that the auditor may consider when obtaining an understanding of the entity’s objectives, strategies, and related business risks that may result in a risk of material misstatement of the financial statements include:

- industry developments (a potential related business risk might be, for example, that the entity does not have the personnel or expertise to deal with the changes in the industry).
- new products and services (a potential related business risk might be, for example, product liability is increased).
- expansion of the business (a potential related business risk might be, for example, that the demand has not been accurately estimated).
- new accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation or a cost increase).
- regulatory requirements (a potential related business risk might be, for example, that legal exposure is increased).
- current and prospective financing requirements (a potential related business risk might be, for example, financing is lost due to the entity’s inability to meet requirements).
- use of IT (a potential related business risk might be, for example, systems and processes are incompatible).
- the effects of implementing a strategy, particularly any effects that will lead to new accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation).

A business risk may have an immediate consequence for the risk of material misstatement for classes of transactions, account balances, and disclosures at the assertion level or the financial statement level. For example, the business risk arising from a contracting customer base may increase the risk of material misstatement associated with the valuation of receivables. However, the same risk, particularly in combination with a contracting economy, also may have a longer term consequence, which may lead the auditor to consider whether those conditions, in the aggregate, indicate that substantial doubt could exist about the entity’s ability to continue as a going concern. Whether a business risk may result in a risk of material misstatement is, therefore, considered in light of the entity’s circumstances. Examples of conditions and events that
may indicate risks of material misstatement are provided in appendix C, "Conditions and Events That May Indicate Risks of Material Misstatement," of AU-C section 315.

Usually, management identifies business risks and develops approaches to address them. Such a risk assessment process is part of internal control and is discussed in paragraphs .16 and .A81–.A83 of AU-C section 315.

Measurement and Review of the Entity’s Financial Performance

Management and others will measure those things they regard as important. Performance measures, whether external or internal, create pressures on the entity that, in turn, may motivate management to take action to improve the business performance or to misstate the financial statements. Accordingly, an understanding of the entity’s performance measures assists the auditor in considering whether pressures to achieve performance targets may result in management actions that increase the risks of material misstatement, including those due to fraud.

The measurement and review of financial performance are not the same as the monitoring of controls (discussed as a component of internal control in paragraphs .23–.25 and .A102–.A107 of AU-C section 315), though their purposes may overlap as follows:

- The measurement and review of performance is directed at whether business performance is meeting the objectives set by management (or third parties).
- Monitoring of controls is specifically concerned with the effective operation of internal control.

In some cases, however, performance indicators also provide information that enables management to identify deficiencies in internal control.

Examples of internally generated information used by management for measuring and reviewing financial performance may include

- key performance indicators (financial and nonfinancial) and key ratios, trends, and operating statistics.
- period-over-period financial analyses.
- budgets; forecasts; variance analysis; segment information; and divisional, departmental, or other level performance reports.

- employee performance measures and incentive compensation policies.

- comparisons of an entity’s performance with that of competitors.

External parties may also measure and review the entity’s financial performance. For example, external information, such as analysts’ reports and credit rating agency reports, may provide information useful to the auditor’s understanding of the entity and its environment. Such reports may be obtained from the entity being audited or from websites.

Internal measures may highlight unexpected results or trends requiring management to determine their cause and take corrective action (including, in some cases, the detection and correction of misstatements on a timely basis). Performance measures also may indicate to the auditor that risks of misstatement of related financial statement information do exist. For example, performance measures may indicate that the entity has unusually rapid growth or profitability when compared with that of other entities in the same industry. Such information, particularly if combined with other factors, such as performance-based bonus or incentive remuneration, may indicate the potential risk of management bias in the preparation of the financial statements.

Considerations specific to smaller, less complex entities. Smaller entities often do not have processes to measure and review financial performance. Inquiry of management may reveal that management relies on certain key indicators for evaluating financial performance and taking appropriate action. If such inquiry indicates an absence of performance measurement or review, an increased risk of misstatements not being detected and corrected may exist.

Internal Control

Refer to section 3125, "Obtaining an Understanding of Internal Control," of this manual for discussion regarding the auditor obtaining an understanding of internal control.
Documentation

.67

The auditor should include in the audit documentation the

- discussion among the engagement team required by paragraph .11 of AU-C section 315, the significant decisions reached, how and when the discussion occurred, and the audit team members who participated;

- key elements of the understanding obtained regarding each of the aspects of the entity and its environment specified in paragraph .12 of AU-C section 315 and each of the internal control components specified in paragraphs .15–.25 of AU-C section 315 (discussed in section 3125 of this manual), the sources of information from which the understanding was obtained, and the risk assessment procedures performed. See section 6000, "Audit Documentation," of this manual for additional discussion on audit documentation.
AAM Section 3125

Obtaining an Understanding of Internal Control

This section contains the following references from AICPA *Professional Standards*:

- AU-C section 230, *Audit Documentation*
- AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
- AU-C section 610, *Using the Work of Internal Auditors*
- AU-C section 705, *Modifications to the Opinion in the Independent Auditor’s Report*

Introduction

.01

*Internal control* is broadly defined by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) as a process, effected by an entity’s board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance.

.02

The previous definition reflects certain fundamental concepts that follow:

**A process.** Internal control is a process. It is not one event or circumstance but a series of ongoing tasks and activities.

**People.** Internal control is effected by people. It is not accomplished by policy manuals and forms but by the people of an organization and the actions that they take. People need to know their responsibilities and limits of authority.

**Reasonable assurance.** Internal control, no matter how well designed and operated, can provide only reasonable assurance to management and the board of directors regarding achievement of an entity's objectives.
Achievement of objectives. Internal control is geared to the achievement of entity objectives. The definitions of these objectives provide auditors with a useful framework for understanding and analyzing internal control.

Adaptable to the entity structure. Internal control should be flexible in its application. This pertains to the how it’s applied to the entity as a whole, or for a particular subsidiary, division, operating unit, or business process.

Obtaining an understanding of and evaluating the design and implementation of controls is different from testing the operating effectiveness of controls. However, the same types of audit procedures are used. Accordingly, the auditor may decide it is efficient to test the operating effectiveness of controls at the same time the auditor is evaluating their design and determining that they have been implemented.

Controls designed to prevent or detect misappropriations of assets may include controls relating to financial reporting and operations objectives. For example, use of a lockbox system for collecting cash or access controls, such as passwords that limit access to the data and programs that process cash disbursements may be relevant to a financial statement audit. Conversely, controls to prevent the excess use of materials in production generally are not relevant to a financial statement audit. Depending on the auditor’s professional judgment, his or her responsibility to understand internal control may be limited to those controls relevant to the reliability of financial reporting.

Auditor Requirements

The Entity’s Internal Control

The auditor should obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor’s professional judgment whether a control, individually or in combination with others, is relevant to the audit.

An understanding of internal control assists the auditor in identifying types of potential misstatements and factors that affect the risks of material misstatement and in designing the nature, timing, and extent of further audit procedures.
Section 4200, "Internal Control Framework," provides additional discussion on the general nature and characteristics of internal control and considerations when determining whether a control, individually or in combination with others, is relevant to the audit.

Nature and Extent of the Understanding of Relevant Controls

When obtaining an understanding of controls that are relevant to the audit, the auditor should evaluate the design of those controls and determine whether they have been implemented by performing procedures in addition to inquiry of the entity’s personnel. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting material misstatements. Implementation of a control means that the control exists and that the entity is using it. Assessing the implementation of a control that is not effectively designed is of little use, and so the design of a control is considered first. An improperly designed control may represent a significant deficiency or material weakness in the entity’s internal control.

Practical example: The Jones family owns and operates several neighborhood grocery stores in Anytown. On a monthly basis, the controller of Jones Grocery performs bank reconciliations for all the bank accounts. For planning purposes, the auditor of Jones Grocery should determine whether this control, individually or in combination with other controls, is capable of effectively preventing or detecting and correcting material misstatements and determine whether the controller actually performs the reconciliations. Identifying and evaluating the design of controls are key parts of audit planning, while testing the implementation of those controls is not.

Risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include

- inquiring of entity personnel.
- observing the application of specific controls.
- inspecting documents and reports.
- tracing transactions through the information system relevant to financial reporting.

Inquiry alone, however, is not sufficient for such purposes.
Obtaining an understanding of an entity’s controls is not sufficient to test their operating effectiveness, unless some automation provides for the consistent operation of the controls. For example, obtaining audit evidence about the implementation of a manual control at a point in time does not provide audit evidence about the operating effectiveness of the control at other times during the period under audit. However, because of the inherent consistency of IT processing, performing audit procedures to determine whether an automated control has been implemented may serve as a test of that control’s operating effectiveness, depending on the auditor’s assessment and testing of controls, such as those over program changes. Tests of the operating effectiveness of controls are further described in AU-C section 330. Refer to section 5200, "Performing Tests of Controls," for additional discussion of AU-C section 330.

Components of Internal Control

**Control Environment**

The auditor should obtain an understanding of the control environment. As part of obtaining this understanding, the auditor should evaluate whether

- management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior and
- the strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control and whether those other components are not undermined by deficiencies in the control environment.

Elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:

- *Communication and enforcement of integrity and ethical values.* Essential elements that influence the effectiveness of the design, administration, and monitoring of controls.

- *Commitment to competence.* Matters such as management’s consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.

- *Participation by those charged with governance.* Attributes of those charged with governance, such as
— their independence from management.
— their experience and stature.
— the extent of their involvement and the information they receive and the scrutiny of activities.
— the appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management.
— their interaction with internal and external auditors.

- *Management’s philosophy and operating style*. Characteristics such as management’s
— approach to taking and managing business risks.
— attitudes and actions toward financial reporting.
— attitudes toward information processing and accounting functions and personnel.

- *Organizational structure*. The framework within which an entity’s activities for achieving its objectives are planned, executed, controlled, and reviewed.

- *Assignment of authority and responsibility*. Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorization hierarchies are established.

- *Human resource policies and practices*. Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counseling, promotion, compensation, and remedial actions.

Relevant audit evidence may be obtained through a combination of inquiries and other risk assessment procedures, such as corroborating inquiries through observation or inspection of documents. For example, through inquiries of management and employees, the auditor may obtain an understanding of how management communicates to employees management’s views on business practices and ethical behavior. The auditor may then determine whether relevant controls have been implemented by considering, for example, whether management has a written code of conduct and whether it acts in a manner that supports the code.
Audit evidence for elements of the control environment in smaller entities may not be available in documentary form, in particular when communication between management and other personnel may be informal, yet effective. For example, smaller entities might not have a written code of conduct but, instead, develop a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example. Consequently, the attitudes, awareness, and actions of management or the owner-manager are of particular importance to the auditor’s understanding of a smaller entity’s control environment.

Section 3130, "Assessing the Risks of Material Misstatement," provides additional discussion on the effects of the control environment on the auditor’s assessment of the risks of material misstatement.

The Entity’s Risk Assessment Process

The auditor should obtain an understanding of whether the entity has a process for

a. identifying business risks relevant to financial reporting objectives,

b. estimating the significance of the risks,

c. assessing the likelihood of their occurrence, and

d. deciding about actions to address those risks.

If the entity has established a risk assessment process (referred to hereafter as the entity’s risk assessment process), the auditor should obtain an understanding of it and the results thereof. If the auditor identifies risks of material misstatement that management failed to identify, the auditor should evaluate whether an underlying risk existed that the auditor expects would have been identified by the entity’s risk assessment process. If such a risk exists, the auditor should obtain an understanding of why that process failed to identify it and evaluate whether the process is appropriate to its circumstances or determine if a significant deficiency or material weakness exists in internal control regarding the entity’s risk assessment process.
If the entity has not established such a process or has an ad hoc process, the auditor should discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed. The auditor should evaluate whether the absence of a documented risk assessment process is appropriate in the circumstances or determine whether it represents a significant deficiency or material weakness in the entity’s internal control.

Considerations specific to smaller, less complex entities. A smaller entity is unlikely to have an established risk assessment process in place. In such cases, it is likely that management will identify risks through direct personal involvement in the business. Irrespective of the circumstances, however, inquiry about identified risks and how they are addressed by management is still necessary.

Risks relevant to financial reporting include external and internal events and circumstances that may occur and adversely affect an entity’s ability to initiate, authorize, record, process, and report financial data consistent with the assertions of management in the financial statements. Risks can arise or change due to circumstances such as the following:

- Changes in operating environment
- New personnel
- New or revamped information systems
- Rapid growth
- New technology
- New business models, products, or activities
- Corporate restructurings
- Expanded foreign operations
- New accounting pronouncements
- Changes in economic conditions
The auditor should obtain an understanding of the information system, including the related business processes relevant to financial reporting, including the following areas:

- The classes of transactions in the entity’s operations that are significant to the financial statements.
- The procedures within both IT and manual systems by which those transactions are initiated, authorized, recorded, processed, corrected as necessary, transferred to the general ledger, and reported in the financial statements.
- The related accounting records supporting information and specific accounts in the financial statements that are used to initiate, authorize, record, process, and report transactions. This includes the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form.
- How the information system captures events and conditions, other than transactions, that are significant to the financial statements.
- The financial reporting process used to prepare the entity’s financial statements, including significant accounting estimates and disclosures.
- Controls surrounding journal entries, including nonstandard journal entries used to record nonrecurring, unusual transactions, or adjustments.

The auditor should obtain an understanding of how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting, including

- communications between management and those charged with governance and
- external communications, such as those with regulatory authorities.

Control Activities Relevant to the Audit
The auditor should obtain an understanding of control activities relevant to the audit, which are those control activities the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them. However, the auditor should obtain an understanding of the process of reconciling detailed records to the general ledger for material account balances.

Control activities that are relevant to the audit are those that are

- required to be treated as such, being control activities that relate to significant risks and those that relate to risks for which substantive procedures alone do not provide sufficient appropriate audit evidence, as required by paragraphs .30–.31 of AU-C section 315, or

- considered to be relevant in the professional judgment of the auditor.

The auditor’s professional judgment about whether a control activity is relevant to the audit is influenced by the risk that the auditor has identified that may give rise to a material misstatement and whether the auditor thinks it is likely to be appropriate to test the operating effectiveness of the control in determining the extent of substantive testing.

The auditor’s emphasis may be on identifying and obtaining an understanding of control activities that address the areas in which the auditor considers that risks of material misstatement are likely to be higher. When multiple control activities each achieve the same objective, it is unnecessary to obtain an understanding of each of the control activities related to such objective.

The auditor’s knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control assists the auditor in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities.
Considerations specific to smaller, less complex entities. The concepts underlying control activities in smaller entities are likely to be similar to those in larger entities, but the formality with which they operate may vary. Further, smaller entities may find that certain types of control activities are not relevant because of controls applied by management. For example, management’s sole authority for granting credit to customers and approving significant purchases can provide strong control over important account balances and transactions, lessening or removing the need for more detailed control activities.

Control activities relevant to the audit of a smaller entity are likely to relate to the main transaction cycles, such as revenues, purchases, and employment expenses.

In understanding the entity’s control activities, the auditor should obtain an understanding of how the entity has responded to risks arising from IT.

Monitoring of Controls

The auditor should obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting, including those related to those control activities relevant to the audit, and how the entity initiates remedial actions to deficiencies in its controls.

If the entity has an internal audit function, the auditor should obtain an understanding of the following in order to determine whether the internal audit function is likely to be relevant to the audit:

- The nature of the internal audit function’s responsibilities and how the internal audit function fits in the entity’s organizational structure
- The activities performed or to be performed by the internal audit function
The entity’s internal audit function is likely to be relevant to the audit if the nature of the internal audit function’s responsibilities and activities are related to the entity’s financial reporting, and the auditor expects to use the work of the internal auditors to modify the nature or timing or reduce the extent of audit procedures to be performed. If the auditor determines that the internal audit function is likely to be relevant to the audit, AU-C section 610 applies. In order to use the work of the internal audit function, the external auditor should evaluate the application by the internal audit function of a systematic and disciplined approach, including quality control. Factors that may affect the external auditor’s determination of whether the internal audit function applies a systematic and disciplined approach include

- the existence, adequacy, and use of documented internal audit procedures or guidance covering such areas as risk assessments, work programs, documentation, and reporting, the nature and extent of which is commensurate with the nature and size of the internal audit function relative to the complexity of the entity.

- whether the internal audit function has appropriate quality control policies and procedures or quality control requirements in standards set by relevant professional bodies for internal auditors. Such bodies may also establish other appropriate requirements, such as conducting periodic external quality assessments.

The objectives of an internal audit function and, therefore, the nature of its responsibilities and its status within the organization, vary widely and depend on the size and structure of the entity and the requirements of management and, when applicable, those charged with governance. The responsibilities of an internal audit function may include, for example, monitoring of internal control, risk management, and review of compliance with laws and regulations. On the other hand, the responsibilities of the internal audit function may be limited to the review of the economy, efficiency, and effectiveness of operations, for example, and, accordingly, may not relate to the entity’s financial reporting.

If the nature of the internal audit function’s responsibilities is related to the entity’s financial reporting, the external auditor’s consideration of the activities performed or to be performed by the internal audit function may include review of the internal audit function’s audit plan for the period, if any, and discussion of that plan with the internal auditors.

The auditor should obtain an understanding of the sources of the information used in the entity’s monitoring activities and the basis upon which management considers the information to be sufficiently reliable for the purpose.
Much of the information used in monitoring may be produced by the entity’s information system. If management assumes that data used for monitoring are accurate without having a basis for that assumption, errors that may exist in the information could potentially lead management to incorrect conclusions from its monitoring activities. Accordingly, an understanding of the following is required as part of the auditor’s understanding of the entity’s monitoring activities component of internal control:

- The sources of the information related to the entity’s monitoring activities
- The basis upon which management considers the information to be sufficiently reliable for the purpose

Other Considerations Regarding Components of Internal Control

Some control components, for example the control environment, will have a pervasive effect on the entity's activities. Other components, for example control activities, will be directed primarily toward the achievement of one or more of the three objectives described in paragraph .01 in this section. Auditors are generally interested only in those components of internal control that have a pervasive effect on the entity and those that are directly related to the reliability of financial reporting.

The aforementioned internal control framework, the relationship between an entity's objectives and internal control components, is discussed in more detail in section 4200 of this manual.

The internal control framework described here and in section 4200 of this manual is only a means to help auditors consider the effect of an entity's internal control in an audit. An auditor's primary concern is not the classification of a specific control into any particular component and related objective. Rather, an auditor's primary concern is whether, and how, a specific control prevents or detects and corrects material misstatements in relevant assertions related to classes of transactions, account balances, or disclosures, rather than its classification into any particular component. Controls relevant to the audit are those that individually or in combination with others are likely to prevent or detect and correct material misstatements in financial statement assertions. Such controls may exist in any of the five components.

Practical example: Andrea Auditor audits Jones Grocery. As on all audits, she should obtain an understanding of internal control sufficient to assess the risks of material misstatement and design the nature, timing, and extent of further audit procedures. To achieve this, she organizes her inquiries and other procedures to understand each of the five components of internal control that relate to the financial reporting objective. As a result of performing her procedures, she discovers the client's bank reconciliation procedures. Should a bank reconciliation be
considered a control activity? What about the fact that someone follows up and investigates old or unusual reconciling items. Is that considered a monitoring activity?

The issue of how to classify a particular control is irrelevant for Andrea's purposes. As an auditor, her primary consideration is to understand how the bank reconciliations, whether individually or in combination with other controls, affect financial statement assertions relating to cash.

Other Considerations When the Auditor Obtains an Understanding of Internal Control

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Auditors might consider the types of misstatements that occurred in prior audits (for example, whether they were associated with accounting estimates, whether they were routine errors that resulted from a lack of control consciousness, or whether they resulted from lack of sufficient personnel). This knowledge of prior misstatements can help an auditor focus his or her inquiries on those areas and whether changes have been made to internal control to prevent those misstatements in the future.

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In a continuing audit, the auditor may already have significant experience with and documentation of internal control. In these situations, this knowledge from previous audits may allow the auditor to focus on system changes.

**Practical example:** Jones Grocery purchased a commercially available software package for independent grocers. During 20X1, Jones installed the general ledger system and the cash receipts/disbursements and accounts payable modules. As part of performing her 20X1 audit, Andrea Auditor obtained an understanding of the software package and the modules that were installed. For her 20X2 audit, Andrea should focus on changes made to the system since 20X1. For example, she might inquire about the installation of other modules (such as inventory) or updated versions of the software package.

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Some controls are documented in policy and procedure manuals, flowcharts, source documents, journals, and ledgers. In these cases, inspection of the documentation and inquiries of entity personnel may provide a sufficient understanding to assess the risks of material misstatement and design the nature, timing, and extent of further audit procedures.

**Practical example:** When Jones Grocery receives a bill, it is input directly into the accounts payable module of their software package. The computer generates an accounts payable aging and a cash requirements report that indicates when each bill should be paid. The accounts payable module interfaces with the general ledger system to automatically post and update the appropriate general ledger account whenever
bills are received or paid. To obtain her understanding of the accounts payable system, Andrea performed a "walk-through." She made inquiries of Jones personnel and obtained copies of bills and the reports generated by the computer. She "walked through" the example bills to see how they were included in the computer reports and how totals from those reports were posted to the general ledger. She also made inquiries related to the completeness assertion, that is, how does Jones ensure that all bills are entered into the system? Andrea observed the Jones employee performing those control procedures.

Documentation may not be available for some controls. For example, the understanding of certain aspects of the control environment, such as management integrity, may be obtained through previous experience updated by inquiries of management and observation of their actions. Although documentation may not be available, this does not alter the requirement that the auditor document his or her understanding of the components of internal control.

Assessing Internal Control Strengths and Weaknesses

When obtaining an understanding of internal control, the auditor may consider the collective effect of strengths and weaknesses in various control environment factors. Management's strengths and weaknesses may have a pervasive effect on internal control. For example, owner-manager controls may mitigate a lack of segregation of duties. However, human resource policies and practices directed toward hiring competent financial and accounting personnel may not mitigate a strong bias by top management to overstate earnings.

Control risk may be assessed in quantitative terms, such as percentages, or in nonquantitative terms (for example, high, medium, or low).

Internal control strengths may indicate account balances, transaction classes, or assertions where you can assess control risk at low or moderate level. Internal control weaknesses usually indicate areas where substantive procedures may be required. However, in situations where electronic evidence (information transmitted, processed, maintained, or accessed by electronic means) is significant, testing of the related internal control generally is necessary to obtain sufficient competent audit evidence.
In rare circumstances, the auditor's understanding of internal control may raise doubts about the auditability of an entity's financial statements. Concerns about the integrity of the entity's management may be so serious that the auditor may conclude that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted. Concerns about the nature and extent of an entity's records also may be so serious that the auditor may conclude that it is unlikely that sufficient appropriate audit evidence will be available to support an opinion on the financial statements.

In situations in which the auditor concludes that it is unlikely that sufficient appropriate audit evidence will be available to support an unmodified opinion on the financial statements, AU-C section 705 establishes requirements and provides guidance regarding the auditor’s determination of whether to express a qualified or adverse opinion or disclaim an opinion or, as may be required in some cases, to withdraw from the engagement when withdrawal is possible under applicable law or regulation.

Additional Resources for Practical Guidance

Readers may refer to appendix K, “Illustrative Audit Documentation Case Study: Young Fashions, Inc.,” of the AICPA Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* for examples of how to document your understanding of internal control. Appendix K contains several subappendixes (appendixes K-1–K-6). Those that are particularly relevant to internal control include the following:

- **Appendix K-2**, “Young Fashions: Evaluation of Entity-Level Controls,” provides example documentation of the auditors evaluation of entity-level controls, except for IT general controls. Appendix K-2 illustrates how to document your understanding of the controls relevant to the audit, including (a) an evaluation of whether the design of the control, individually or in combination, is capable of effectively preventing or detecting and correcting material misstatements and (b) a determination of whether the control exists and the entity is using it.

- **Appendix K-2-1**, “Young Fashions: Procedures Performed to Evaluate Entity-Level Controls,” provides illustrative documentation for the risk assessment and other procedures an auditor performs to obtain the required understanding about internal control and the source of that understanding.

- **Appendix K-3**, “Young Fashions: Understanding of Internal Control—IT General Controls,” provides example documentation of the auditors evaluation of IT general controls.

- **Appendix K-4**, “Young Fashions: Evaluation of Activity-Level Controls—Wholesale Sales,” provides example documentation of an evaluation of activity-level controls. This case study presents only one class of transactions, sales. In practice, the auditor would evaluate activity-level controls for each significant class of transactions.

**Documenting the Understanding**
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The auditor should include in the audit documentation the

- discussion among the engagement team required by paragraph .11 of AU-C section 315, the significant decisions reached, how and when the discussion occurred, and the audit team members who participated, and

- key elements of the understanding obtained regarding each of the aspects of the entity and its environment specified in paragraph .12 of AU-C section 315 and each of the components of internal control specified in paragraphs .15–.25 of AU-C section 315, the sources of information from which the understanding was obtained, and the risk assessment procedures performed.

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The manner in which the requirements of paragraph .33 of AU-C section 315 are documented is for the auditor to determine exercising professional judgment. For example, in audits of smaller entities, the documentation may be incorporated in the auditor’s documentation of the overall strategy and audit plan. Similarly, the results of the risk assessment may be documented separately, or they may be documented as part of the auditor’s documentation of further audit procedures. The form and extent of the documentation is influenced by the nature, size, and complexity of the entity and its internal control; availability of information from the entity; and the audit methodology and technology used in the course of the audit.

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For entities that have uncomplicated businesses and processes relevant to financial reporting, the documentation may be simple and relatively brief. It is not necessary to document the entirety of the auditor’s understanding of the entity and matters related to it. Key elements of the understanding documented by the auditor include those on which the auditor based the assessment of the risks of material misstatement.

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The extent of documentation also may reflect the experience and capabilities of the members of the audit engagement team. Provided that the requirements of AU-C section 230 are met, an audit undertaken by an engagement team comprising less experienced individuals may contain more detailed documentation to assist them to obtain an appropriate understanding of the entity than one that includes experienced individuals.

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For recurring audits, certain documentation may be carried forward and updated as necessary to reflect changes in the entity’s business or processes.