The Auditor’s Report on Financial Statements
Proposed revisions to ISA 200

Clean version (*Mark-up version begins on page II*)

ISA 200, OBJECTIVES AND GENERAL PRINCIPLES GOVERNING AN AUDIT OF
FINANCIAL STATEMENTS

Introduction
1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the objective and general principles governing an audit of financial statements.

Objective of an Audit
2. The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with a financial reporting framework.

3. The term “financial statements” refers to a presentation of financial data, including accompanying notes, derived from accounting records and intended to communicate an entity’s economic resources or obligations at a point in time or the changes therein for a period of time in conformity with a financial reporting framework. The term can refer to a complete set of financial statements, but it can also refer to an individual financial statement such as a balance sheet and the related explanatory notes.

4. The requirements of the financial reporting framework determine what constitutes a complete set of financial statements. For example, International Financial Reporting Standards state that a complete set of financial statements includes a balance sheet, an income statement, a statement of changes in equity, a cash flow statement and a summary of significant accounting policies and other explanatory notes.

5. Although the auditor’s opinion enhances the credibility of the financial statements, readers of the auditor’s report need to read the financial statements prepared by management in order to obtain an understanding of the information contained therein, (for example, information about an entity’s financial position, financial performance and cash flows in the case of general purpose financial statements). Further, readers of the auditor’s report cannot assume that the opinion is an assurance as to the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity.
General Principles of an Audit

ETHICAL REQUIREMENTS

6. The auditor should comply with the relevant ethical requirements relating to audit engagements, which ordinarily comprise Parts A and B of the “Code of Ethics for Professional Accountants” issued by the International Federation of Accountants together with applicable national requirements where these are more restrictive. Ethical principles governing the auditor’s professional responsibilities are:

(a) Independence;
(b) Integrity;
(c) Objectivity;
(d) Professional competence and due care;
(e) Confidentiality;
(f) Professional behavior; and
(g) Technical standards.

In addition, under International Standard on Quality Control 1 (ISQC 1), a firm of professional accountants has an obligation to establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and applicable regulatory and legal requirements and that the auditor’s reports issued by the firm or engagement partners are appropriate in the circumstances.

CONDUCT OF AN AUDIT

7. The auditor should conduct the audit in accordance with ISAs.

8. ISAs contain basic principles and essential procedures together with related guidance in the form of explanatory and other material, including appendices. The basic principles and essential procedures are to be understood and applied in the context of explanatory and other material that provide guidance for their application. The text of a whole Standard is considered in order to understand and apply the basic principles and essential procedures.

9. In conducting an audit in accordance with ISAs, the auditor is also aware of and considers IAPSs applicable to the audit engagement. IAPSs provide interpretive guidance and practical assistance to auditors in implementing ISAs. An auditor who does not apply the guidance included in a relevant IAPS needs to be prepared to explain how the basic principles and essential procedures in the Standard addressed by the IAPS have been complied with.

10. The auditor may also conduct the audit to comply with both ISAs and national standards applicable in another jurisdiction.

SCOPE OF AN AUDIT

11. The term “scope of an audit” refers to the audit procedures deemed necessary in the circumstances to achieve the objective of the audit.
12. In determining the audit procedures to be performed in conducting an audit in accordance with ISAs, the auditor should comply with each of the ISAs relevant to the audit. The auditor should also have regard to the requirements of relevant professional bodies, legislation, regulations and, where appropriate, the terms of the audit engagement.

13. Auditors may have a number of professional and legal requirements, with which they must comply in addition to the ISAs. The ISAs cannot override the local laws and regulations that govern an audit of financial statements. In the event those laws and regulations differ from the ISAs, an audit conducted in accordance with the local laws and regulations will not automatically comply with ISAs.

14. When the auditor is conducting the audit in accordance with auditing standards of a particular jurisdiction as well as ISAs, in addition to complying with ISAs the auditor also performs any additional audit procedures necessary to comply with the relevant standards of that jurisdiction.

15. The auditor should not represent compliance with ISAs unless the auditor has complied fully with all of the ISAs relevant to the engagement.

Professional skepticism

16. The auditor should plan and perform an audit with an attitude of professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated. An attitude of professional skepticism means the auditor makes a critical assessment, with a questioning mind, of the validity of audit evidence obtained and is alert to audit evidence that contradicts or brings into question the reliability of documents or management representations. For example, an attitude of professional skepticism is necessary throughout the audit process for the auditor to reduce the risk of overlooking suspicious circumstances, of over generalizing when drawing conclusions from audit observations, and of using faulty assumptions in determining the nature, timing and extent of the audit procedures and evaluating the results thereof. In planning and performing an audit, the auditor neither assumes that management is dishonest nor assumes unquestioned honesty. Accordingly, representations from management are not a substitute for obtaining sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the opinion on the financial statements.

Reasonable assurance

17. An audit in accordance with ISAs is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement. Reasonable assurance is a concept relating to the accumulation of the audit evidence necessary for the auditor to conclude that there are no material misstatements in the financial statements taken as a whole. Reasonable assurance relates to the whole audit process.

18. However, there are inherent limitations in an audit that affect the auditor’s ability to detect material misstatements. These limitations result from factors such as:

- The use of testing.
- The inherent limitations of internal control (for example, the possibility of management override and collusion).
• The fact that most audit evidence is persuasive rather than conclusive.

19. Also, the work undertaken by the auditor to form an opinion is permeated by judgment, in particular regarding:
   (a) The gathering of audit evidence, for example, in deciding the nature, timing and extent of audit procedures; and
   (b) The drawing of conclusions based on the audit evidence gathered, for example, assessing the reasonableness of the estimates made by management in preparing the financial statements.

20. Further, other limitations may affect the persuasiveness of audit evidence available to draw conclusions on particular assertions1 (for example, transactions between related parties). In these cases certain ISAs identify specified audit procedures which will, because of the nature of the particular assertions, provide sufficient appropriate audit evidence in the absence of:
   (a) Unusual circumstances which increase the risk of material misstatement beyond that which would ordinarily be expected; or
   (b) Any indication that a material misstatement has occurred.

21. Accordingly, an audit is not a guarantee that the financial statements are free of material misstatement, because absolute assurance is not attainable.

AUDIT RISK AND MATERIALITY

22. Entities pursue strategies to achieve their objectives, and depending on the nature of their operations and industry, the regulatory environment in which they operate, and their size and complexity, they face a variety of business risks2. Management is responsible for identifying such risks and responding to them. However, not all risks relate to the preparation of the financial statements. The auditor is ultimately concerned only with risks that may affect the financial statements.

23. The auditor obtains and evaluates audit evidence to obtain reasonable assurance about whether the financial statements give a true and fair view (or are presented fairly, in all material respects) in accordance with the applicable financial reporting framework. The concept of reasonable assurance acknowledges that there is a risk the audit opinion is inappropriate. The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated is known as “audit risk.”3

24. **The auditor should plan and perform the audit to reduce audit risk to an acceptably low level that is consistent with the objective of an audit.** The auditor reduces audit risk by designing and performing audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base an audit opinion. Reasonable assurance is obtained when the auditor has reduced audit risk to an acceptably low level.

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1 Paragraphs XX – XX of ISA 500 “Audit Evidence” discuss the concept of assertions.
2 Paragraph XX of ISA XX “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement” discusses the concept of business risks.
3 This definition of audit risk does not include the risk that the auditor might erroneously conclude that the financial statements are materially misstated. This definition also excludes the risk of an inappropriate reporting decision notwithstanding the audit evidence obtained.
25. Audit risk is a function of the risk of material misstatement of the financial statements (or simply, the “risk of material misstatement”) (i.e., the risk that the financial statements are materially misstated prior to audit) and the risk that the auditor will not detect such misstatement (“detection risk”). The auditor performs audit procedures to assess the risk of material misstatement and seeks to limit detection risk by performing further audit procedures based on that assessment (see ISA XX, “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement,” and ISA XX, “The Auditor’s Procedures in Response to Assessed Risks”). The audit process involves the exercise of professional judgment in designing the audit approach, through focusing on what can go wrong (i.e., what are the potential misstatements that may arise) at the assertion level (see ISA XX, “Audit Evidence”) and performing audit procedures in response to the assessed risks in order to obtain sufficient appropriate audit evidence.

26. The auditor is concerned with material misstatements, and is not responsible for the detection of misstatements that are not material to the financial statements taken as a whole. The auditor considers whether the effect of identified uncorrected misstatements, both individually and in the aggregate, is material to the financial statements taken as a whole. Materiality and audit risk are related (see ISA 320 “Audit Materiality”). In order to design audit procedures to determine whether there are misstatements that are material to the financial statements taken as a whole, the auditor considers risk and materiality at two levels: the overall financial statement level and in relation to classes of transactions, account balances, and disclosures and the related assertions.

27. The auditor considers the risk of material misstatement at the overall financial statement level, which refers to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature often relate to the entity’s control environment (although these risks may also relate to other factors, such as declining economic conditions), and are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Rather, this overall risk represents circumstances that increase the risk that there could be material misstatements in any number of different assertions, for example, through management override of internal control. Such risks may be especially relevant to the auditor’s consideration of the risk of material misstatement arising from fraud. The auditor’s response to the assessed risk of material misstatement at the overall financial statement level includes consideration of the knowledge, skill, and ability of personnel assigned significant engagement responsibilities, including whether to involve experts; the appropriate levels of supervision; and whether there are events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern.

28. The auditor also considers the risk of material misstatement at the class of transactions, account balance, and disclosure level because such consideration directly assists in determining the nature, timing, and extent of further audit procedures at the assertion level.

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4 ISA XX “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement” provides additional guidance on the auditor’s requirement to assess risks of material misstatement at the financial statement level and at the assertion level.

5 ISA XX “The Auditor’s Procedures in Response to Assessed Risks” provides additional guidance on the requirement for the auditor to design and perform further audit procedures in response to the assessed risks at the assertion level.
The auditor seeks to reduce risks at the class of transactions, account balance, and disclosure level in such a way that enables the auditor, at the completion of the audit, to express an opinion on the financial statements taken as a whole at an acceptably low level of audit risk. Auditors use various approaches to accomplish that objective.6

29. The discussion in the following paragraphs provides an explanation of the components of audit risk. The risk of material misstatement at the assertion level consists of two components as follows:

- “Inherent risk” is the susceptibility of an assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there are no related controls. The risk of such misstatement is greater for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, complex calculations are more likely to be misstated than simple calculations. Accounts consisting of amounts derived from accounting estimates that are subject to significant measurement uncertainty pose greater risks than do accounts consisting of relatively routine, factual data. 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. In addition to those circumstances that are peculiar to a specific assertion, factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may influence the inherent risk related to a specific assertion. These latter factors 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” is the risk that a misstatement that could occur in an assertion 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. That risk is a function of the effectiveness of the design and operation of internal control in achieving the entity’s objectives relevant to preparation of the entity’s financial statements. Some control risk will always exist because of the inherent limitations of internal control.

30. Inherent risk and control risk are the entity’s risks; they exist independently of the audit of the financial statements. The auditor is required to assess the risk of material misstatement at the assertion level as a basis for further audit procedures, though that assessment is a judgment, rather than a precise measurement of risk. The ISAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the “risk of material misstatement.” Although the ISAs ordinarily describe a combined assessment of the risk of material misstatement, 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 risk of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any

6 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 appropriate level of detection risk. Some auditors find such a model to be useful when planning audit procedures to achieve a desired audit risk though the use of such a model does not eliminate the judgment inherent in the audit process.
case, the need for the auditor to make appropriate risk assessments is more important than
the different approaches by which they may be made.

31. “Detection risk” is the risk that the auditor will not detect a misstatement that exists in an
assertion that could be material, either individually or when aggregated with other
misstatements. Detection risk is a function of the effectiveness of an audit procedure and of
its application by the auditor. Detection risk cannot be reduced to zero because the auditor
usually does not examine all of a class of transactions, account balance, or disclosure and
because of other uncertainties. Such other uncertainties arise because an auditor might select
an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret
the audit results. These other uncertainties ordinarily can be reduced to an acceptably low
level through adequate planning, proper assignment of personnel to the engagement team,
the application of professional skepticism, and supervision and review of the audit work
performed.

32. 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. For a given level
of audit risk, the acceptable level of detection risk bears an inverse relationship to the
assessment of the risk of material misstatement at the assertion level. The greater the risk of
material misstatement the auditor believes exists, the less the detection risk that can be
accepted. Conversely, the less risk of material misstatement the auditor believes exist, the
greater the detection risk that can be accepted.

RESPONSIBILITY FOR THE FINANCIAL STATEMENTS

33. While the auditor is responsible for forming and expressing an opinion on the financial
statements, the responsibility for preparing and presenting the financial statements is that of
the management of the entity.

34. In the case of general purpose financial statements, management’s responsibilities for
preparing and presenting fairly the financial position, financial performance and cash flows
of an entity in accordance with a financial reporting framework include:

(a) Identifying the financial reporting framework to be used in preparing the financial
    statements;

(b) Designing and implementing internal controls to prevent and detect fraud and error;

(c) Selecting and applying accounting policies that are consistent with the applicable
    financial reporting framework and appropriate in the circumstances; and

(d) Making necessary accounting estimates, including the significant assumptions on
    which those estimates are based.

Management is also responsible for approving and issuing the financial statements. The
audit of the financial statements does not relieve management of its responsibilities.

35. The term management has been used to describe those responsible for the preparation and
presentation of the financial statements. This term will vary according to the legal
framework in each jurisdiction.
FINANCIAL REPORTING FRAMEWORK

36. The financial reporting framework used by management to prepare the financial statements will depend on the users of these statements and on how their needs are addressed in a particular jurisdiction. In some cases, the financial statements will be intended to meet the common information needs of a wide range of users; in others, they will be intended to meet the specific needs of specifically identified users.

37. Many users of financial statements are not in a position to demand reports tailored to meet their specific information needs. Financial statements that are intended to meet the common information needs of that wide range of users are referred to as general purpose financial statements. While all the information needs of specific users cannot be met by the general purpose financial statements made available by an entity, these are needs that are common to all users. In a profit-oriented enterprise, as investors are providers of risk capital to the enterprise, it is presumed that financial statements that meet their needs will also meet most of the needs of other users in making economic decisions.

38. The objective of general purpose financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to that wide range of users in making economic decisions.

Acceptable financial reporting frameworks for general purpose financial statements

39. The following financial reporting frameworks are presumed to be acceptable for general purpose financial statements:

(a) International Financial Reporting Standards (or, in the case of public sector entities other than Government Business Enterprises, International Public Sector Accounting Standards7);

(b) Established financial reporting standards in a particular jurisdiction;

(c) Other specifically developed financial reporting frameworks provided they are comprehensive and authoritative.

ISA 700 “The Auditor’s Report on Financial Statements” addresses the auditor’s report on such general purpose financial statements.

40. In special purpose audit engagements, a complete set of financial statements may be prepared using other bases of accounting that are designed to meet other objectives of users. Alternatively, an individual financial statement such as a balance sheet and related notes may also be prepared. The needs of the identified users will determine the applicable financial reporting framework in such circumstances. ISA 800 “The Auditor’s Report on Special Purpose Audit Engagements” addresses the auditor’s report on such financial statements.

International Financial Reporting Standards

41. Paragraphs 10 to 19 of International Accounting Standard (IAS) 1 (Revised 1997), “Presentation of Financial Statements,”8 set out the requirements to be met before an entity’s

7 Refer to “Preface to International Public Sector Accounting Standards” for more information on International Public Sector Accounting Standards.

8 On May 15, 2002, the International Accounting Standards Board issued an exposure draft of improvements to IASs, including an exposure draft of a proposed revised IAS 1. In that exposure draft, the relevant paragraphs are paragraphs 10-17, with paragraph 11 requiring compliance with all applicable standards.
financial statements can be regarded as having been prepared in accordance with International Financial Reporting Standards (also referred to as International Accounting Standards). In particular, paragraph 11 indicates that “financial statements should not be described as complying with International Accounting Standards unless they comply with all the requirements of each applicable standard and each applicable interpretation of the Standing Interpretations Committee.”

Established financial reporting standards in a particular jurisdiction

42. Established financial reporting standards in a particular jurisdiction refers to standards issued or adopted by national organizations authorized, for example, by legislation, to promulgate standards in their jurisdiction through an established process involving deliberation and consultation.

Other specifically developed financial reporting frameworks provided they are comprehensive and authoritative

43. Specifically developed financial reporting frameworks may be acceptable in jurisdictions that do not require the use of standards such as International Financial Reporting Standards or that do not have established financial reporting standards provided they are comprehensive and authoritative.

44. A specifically developed financial reporting framework would be considered to be comprehensive when it is:

   (a) Relevant to the common information needs of a wide range of users in that it is designed to result in financial statements that will help users make economic decisions by presenting fairly the financial position, financial performance and cash flows of an entity.

   (b) Complete in that relevant factors that could affect the fair presentation of the financial position, financial performance and cash flows of the financial statements are not omitted.

   (c) Reliable in that it:

      (i) reflects the economic substance of events and transactions and not merely their legal form; and

      (ii) results in reasonably consistent evaluation, measurement, presentation and disclosure, when used in similar circumstances;

   (e) Neutral in that it is free from bias; and

   (f) Understandable in that it is clear and comprehensive and not subject to significantly different interpretation.

45. A specifically developed financial reporting framework would be considered to be authoritative when it represents prevalent practice in a particular jurisdiction or industry. A conglomeration of accounting conventions devised to suit individual preferences would not be considered to be a comprehensive and authoritative financial reporting framework.

9 The Standing Interpretations Committee was renamed the “International Financial Reporting Interpretations Committee” subsequent to the issue of IAS 1 (Revised 1997).
Identification of Applicable Financial Reporting Framework for General Purpose Financial Statements

46. The legislative and regulatory obligations of the entity often determines the financial reporting framework to be used in preparing the entity’s general purpose financial statements, hereinafter referred to as the applicable financial reporting framework.

47. Legislation in some jurisdictions sometimes also requires financial statements to comply with certain specified requirements. In these jurisdictions, the applicable financial reporting framework encompasses both the financial reporting framework and the additional requirements specified in legislation.

48. When the entity is registered or operating in a jurisdiction where there are no such legislative and regulatory obligations, the entity identifies an applicable framework. The entity’s choice will be governed by local practice, industry practice, user needs, or other factors. For example, the entity’s competitors may apply International Financial Reporting Standards and the entity may determine that International Financial Reporting Standards are also appropriate for its financial reporting requirements.
Proposed Revisions to ISA 200

Mark up

Note to IAASB:

Paragraphs 1 to 35 are marked to show proposed changes to the wording of ISA 200 presented to IAASB by the Audit Risk Task Force. *Words in italics* indicate changes made by the Audit Risk Task Force to the original ISA 200 wording.

Paragraphs 36 to 48 were not considered by the Audit Risk Task Force. The mark-up included in this agenda paper is a mark-up of the wording presented by the Reporting Task Force to IAASB in July.

PROPOSED REVISED ISA 200, OBJECTIVES AND GENERAL PRINCIPLES GOVERNING AN AUDIT OF FINANCIAL STATEMENTS

**Introduction**

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the objective and general principles governing an audit of financial statements.

**Objective of an Audit**

2. The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an [applicable financial reporting framework]. The phrases used to express the auditor’s opinion are “give a true and fair view” or “present fairly, in all material respects,” which are equivalent terms.

3. The term “financial statements” refers to a presentation of financial data, including accompanying notes, derived from accounting records and intended to communicate an entity’s economic resources or obligations at a point in time or the changes therein for a period of time in conformity with a financial reporting framework. The term can refer to a complete set of financial statements, but it can also refer to an individual financial statement such as a balance sheet and the related explanatory notes.

4. The requirements of the financial reporting framework determine what constitutes a complete set of financial statements. For example, International Financial Reporting Standards state that a complete set of financial statements includes a balance sheet, an income statement, a statement of changes in equity, a cash flow statement and a summary of significant accounting policies and other explanatory notes.

5. Although the auditor’s opinion enhances the credibility of the financial statements, readers of the auditor’s report need to read the financial statements prepared by management in order to obtain an understanding of the information contained therein, (for example, information about an entity’s financial position, financial performance and cash flows in the case of general purpose financial statements). Further, readers of the auditor’s report the user cannot
assume that the audit opinion is an assurance as to the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity.

General Principles of an Audit

**ETHICAL REQUIREMENTS**

4. The auditor should comply with the relevant ethical requirements relating to audit engagements, which ordinarily comprise Parts A and B of the “Code of Ethics for Professional Accountants” issued by the International Federation of Accountants together with applicable national requirements where these are more restrictive. Ethical principles governing the auditor’s professional responsibilities are:

(a) Independence;
(b) Integrity;
(c) Objectivity;
(d) Professional competence and due care;
(e) Confidentiality;
(f) Professional behavior; and
(g) Technical standards.

In addition, under International Standard on Quality Control 1 (ISQC 1), a firm of professional accountants has an obligation to establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and applicable regulatory and legal requirements and that the auditor’s reports issued by the firm or engagement partners are appropriate in the circumstances.

**CONDUCT OF AN AUDIT**

5. The auditor should conduct the audit in accordance with ISAs. These contain basic principles and essential procedures together with related guidance in the form of explanatory and other material.

6. The auditor should plan and perform an audit with an attitude of professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated. An attitude of professional skepticism means the auditor makes a critical assessment, with a questioning mind, of the validity of audit evidence obtained and is alert to audit evidence that contradicts or brings into question the reliability of documents or management representations. For example, an attitude of professional skepticism is necessary throughout the audit process for the auditor to reduce the risk of overlooking suspicious circumstances, of overgeneralizing when drawing conclusions from audit observations, and of using faulty assumptions in determining the nature, timing and extent of the audit procedures and evaluating the results thereof. In planning and performing an audit, the auditor neither assumes that management is dishonest nor assumes unquestioned honesty. Accordingly, representations from management are not a substitute for obtaining
sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion. 1 \[Moved to paragraph 16.\]

8. ISAs contain basic principles and essential procedures together with related guidance in the form of explanatory and other material, including appendices. The basic principles and essential procedures are to be understood and applied in the context of explanatory and other material that provide guidance for their application. The text of a whole Standard is considered in order to understand and apply the basic principles and essential procedures.

9. In conducting an audit in accordance with ISAs, the auditor is also aware of and considers IAPSs applicable to the audit engagement. IAPSs provide interpretive guidance and practical assistance to auditors in implementing ISAs. An auditor who does not apply the guidance included in a relevant IAPS needs to be prepared to explain how the basic principles and essential procedures in the Standard addressed by the IAPS have been complied with.

10. The auditor may also conduct the audit to comply with both ISAs and national standards applicable in another jurisdiction.

SCOPE OF AN AUDIT

11. The term “scope of an audit” refers to the audit procedures deemed necessary in the circumstances to achieve the objective of the audit.

12. In determining the procedures to be performed in conducting an audit in accordance with ISAs, the auditor should comply with each of the ISAs relevant to the audit. The auditor should also have regard to the requirements of relevant professional bodies, legislation, regulations and, where appropriate, the terms of the audit engagement and reporting requirements.

13. Auditors may have a number of professional and legal requirements, with which they must comply in addition to the ISAs. The ISAs cannot override the local laws and regulations that govern an audit of financial statements. In the event those laws and regulations differ from the ISAs, an audit conducted in accordance with the local laws and regulations will not automatically comply with ISAs.

14. When the auditor is conducting the audit in accordance with auditing standards of a particular jurisdiction as well as ISAs, in addition to complying with ISAs the auditor also performs any additional audit procedures necessary to comply with the relevant standards of that jurisdiction.

\[Paragraph 6 reflects the changes indicated in ISA 240, “The Auditor’s Responsibility to Consider Fraud and Error in an Audit of Financial Statements” and is effective for audits of financial statements for periods ending on or after June 30, 2002. The original Paragraph 6 is indicated below: \]

The auditor should have regard to the requirements of relevant professional bodies, legislation, regulations and, where appropriate, the terms of the audit engagement and reporting requirements.

\[For example, the auditor would ordinarily expect to find evidence to support management representations and not assume they are necessarily correct.\]
15. **The auditor should not represent compliance with ISAs unless the auditor has complied fully with all of the ISAs relevant to the engagement.**

**PROFESSIONAL SKEPTICISM**

616. **The auditor should plan and perform an audit with an attitude of professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated.** An attitude of professional skepticism means the auditor makes a critical assessment, with a questioning mind, of the validity of audit evidence obtained and is alert to audit evidence that contradicts or brings into question the reliability of documents or management representations. For example, an attitude of professional skepticism is necessary throughout the audit process for the auditor to reduce the risk of overlooking suspicious circumstances, of over generalizing when drawing conclusions from audit observations, and of using faulty assumptions in determining the nature, timing and extent of the audit procedures and evaluating the results thereof. In planning and performing an audit, the auditor neither assumes that management is dishonest nor assumes unquestioned honesty. Accordingly, representations from management are not a substitute for obtaining sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion on the financial statements.

**REASONABLE ASSURANCE**

817. An audit in accordance with ISAs is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement. Reasonable assurance is a concept relating to the accumulation of the audit evidence necessary for the auditor to conclude that there are no material misstatements in the financial statements taken as a whole. Reasonable assurance relates to the whole audit process.

918. However, there are inherent limitations in an audit that affect the auditor’s ability to detect material misstatements. These limitations result from factors such as:

- The use of testing.
- The inherent limitations of internal control (for example, the possibility of management override and collusion).
- The fact that most audit evidence is persuasive rather than conclusive.

4919. Also, the work undertaken by the auditor to form an opinion is permeated by judgment, in particular regarding:

(a) The gathering of audit evidence, for example, in deciding the nature, timing and extent of audit procedures; and

(b) The drawing of conclusions based on the audit evidence gathered, for example, assessing the reasonableness of the estimates made by management in preparing the financial statements.

4420. Further, other limitations may affect the persuasiveness of audit evidence available to draw conclusions on particular assertions for example, transactions between related parties. In

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2 Paragraphs XX – XX of ISA 500 “Audit Evidence” discuss the concept of assertions.
these cases certain ISAs identify specified audit procedures which will, because of the nature of the particular assertions, provide sufficient appropriate audit evidence in the absence of:

(a) Unusual circumstances which increase the risk of material misstatement beyond that which would ordinarily be expected; or

(b) Any indication that a material misstatement has occurred.

Accordingly, an audit is not a guarantee that the financial statements are free of material misstatement, because absolute assurance is not attainable.

**AUDIT RISK AND MATERIALITY**

Entities pursue strategies to achieve their objectives, and depending on the nature of their operations and industry, the regulatory environment in which they operate, and their size and complexity, they face a variety of business risks. Management is responsible for identifying such risks and responding to them. However, not all risks relate to the preparation of the financial statements. The auditor is ultimately concerned only with risks that may affect the financial statements.

The auditor obtains and evaluates audit evidence to obtain reasonable assurance about whether the financial statements give a true and fair view (or are presented fairly, in all material respects) in accordance with the applicable financial reporting framework. The concept of reasonable assurance acknowledges that there is a risk the audit opinion is inappropriate. The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated is known as “audit risk.”

The auditor should plan and perform the audit to reduce audit risk to an acceptably low level that is consistent with the objective of an audit. The auditor reduces audit risk by designing and performing audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base an audit opinion. Reasonable assurance is obtained when the auditor has reduced audit risk to an acceptably low level.

Audit risk is a function of the risk of material misstatement of the financial statements (or simply, the “risk of material misstatement”) (i.e., the risk that the financial statements are materially misstated prior to audit) and the risk that the auditor will not detect such misstatement (“detection risk”). The auditor performs audit procedures to assess the risk of material misstatement and seeks to limit detection risk by performing further audit procedures based on that assessment (see ISA XX, “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement,” and ISA XX, “The Auditor’s Procedures in Response to Assessed Risks”). The audit process involves the exercise of professional judgment in designing the audit approach, through focusing on what

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2 Paragraph XX of ISA XX “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement” discusses the concept of business risks.

3 This definition of audit risk does not include the risk that the auditor might erroneously conclude that the financial statements are materially misstated. This definition also excludes the risk of an inappropriate reporting decision notwithstanding the audit evidence obtained.
can go wrong (i.e., what are the potential misstatements that may arise) at the assertion level (see ISA XX, “Audit Evidence”) and performing audit procedures in response to the assessed risks in order to obtain sufficient appropriate audit evidence.

426. The auditor is concerned with material misstatements, and is not responsible for the detection of misstatements that are not material to the financial statements taken as a whole. The auditor considers whether the effect of identified uncorrected misstatements, both individually and in the aggregate, is material to the financial statements taken as a whole. Materiality and audit risk are related (see ISA 320 “Audit Materiality”). In order to design audit procedures to determine whether there are misstatements that are material to the financial statements taken as a whole, the auditor considers risk and materiality at two levels: the overall financial statement level and in relation to classes of transactions, account balances, and disclosures and the related assertions.

427. The auditor considers the risk of material misstatement at the overall financial statement level, which refers to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature often relate to the entity’s control environment (although these risks may also relate to other factors, such as declining economic conditions), and are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Rather, this overall risk represents circumstances that increase the risk that there could be material misstatements in any number of different assertions, for example, through management override of internal control. Such risks may be especially relevant to the auditor’s consideration of the risk of material misstatement arising from fraud. The auditor’s response to the assessed risk of material misstatement at the overall financial statement level includes consideration of the knowledge, skill, and ability of personnel assigned significant engagement responsibilities, including whether to involve experts; the appropriate levels of supervision; and whether there are events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern.

428. The auditor also considers the risk of material misstatement at the class of transactions, account balance, and disclosure level because such consideration directly assists in determining the nature, timing, and extent of further audit procedures at the assertion level. The auditor seeks to reduce risks at the class of transactions, account balance, and disclosure level in such a way that enables the auditor, at the completion of the audit, to express an opinion on the financial statements taken as a whole at an acceptably low level of audit risk. Auditors use various approaches to accomplish that objective.

4 ISA XX “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement” provides additional guidance on the auditor’s requirement to assess risks of material misstatement at the financial statement level and at the assertion level.

5 ISA XX “The Auditor’s Procedures in Response to Assessed Risks” provides additional guidance on the requirement for the auditor to design and perform further audit procedures in response to the assessed risks at the assertion level.

6 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 appropriate level of detection risk. Some auditors find such a model to be useful when planning audit procedures to achieve a desired audit risk though the use of such a model does not eliminate the judgment inherent in the audit process.
2029. The discussion in the following paragraphs provides an explanation of the components of audit risk. The risk of material misstatement at the assertion level consists of two components as follows:

- "Inherent risk" is the susceptibility of an assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there are no related controls. The risk of such misstatement is greater for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, complex calculations are more likely to be misstated than simple calculations. Accounts consisting of amounts derived from accounting estimates that are subject to significant measurement uncertainty pose greater risks than do accounts consisting of relatively routine, factual data. 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. In addition to those circumstances that are peculiar to a specific assertion, factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may influence the inherent risk related to a specific assertion. These latter factors 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" is the risk that a misstatement that could occur in an assertion 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. That risk is a function of the effectiveness of the design and operation of internal control in achieving the entity’s objectives relevant to preparation of the entity’s financial statements. Some control risk will always exist because of the inherent limitations of internal control.

2430. Inherent risk and control risk are the entity’s risks; they exist independently of the audit of the financial statements. The auditor is required to assess the risk of material misstatement at the assertion level as a basis for further audit procedures, though that assessment is a judgment, rather than a precise measurement of risk. The ISAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the “risk of material misstatement.” Although the ISAs ordinarily describe a combined assessment of the risk of material misstatement, 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 risk of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative 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.

2331. “Detection risk” is the risk that the auditor will not detect a misstatement that exists in an assertion that could be material, either individually or when aggregated with other misstatements. Detection risk is a function of the effectiveness of an audit procedure and of its application by the auditor. Detection risk cannot be reduced to zero because the auditor usually does not examine all of a class of transactions, account balance, or disclosure and because of other uncertainties. Such other uncertainties arise because an auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results. These other uncertainties ordinarily can be reduced to an acceptably low level through adequate planning, proper assignment of personnel to the
engagement team, the application of professional skepticism, and supervision and review of the audit work performed.

2332. 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. For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessment of the risk of material misstatement at the assertion level. The greater the risk of material misstatement the auditor believes exists, the less the detection risk that can be accepted. Conversely, the less risk of material misstatement the auditor believes exist, the greater the detection risk that can be accepted.

RESPONSIBILITY FOR THE FINANCIAL STATEMENTS

2433. While the auditor is responsible for forming and expressing an opinion on the financial statements, the responsibility for preparing and fairly presenting the financial statements in accordance with the applicable financial reporting framework is that of the management of the entity, with oversight from those charged with governance.

34. In the case of general purpose financial statements, management’s responsibilities for preparing and presenting fairly the financial position, financial performance and cash flows of an entity in accordance with a financial reporting framework include:

(a) Identifying the financial reporting framework to be used in preparing the financial statements;
(b) Designing and implementing internal controls to prevent and detect fraud and error;
(c) Selecting and applying accounting policies that are consistent with the applicable financial reporting framework and appropriate in the circumstances; and
(d) Making necessary accounting estimates, including the significant assumptions on which those estimates are based.

Management is also responsible for approving and issuing the financial statements. The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

35. The term management has been used to describe those responsible for the preparation and presentation of the financial statements. This term will vary according to the legal framework in each jurisdiction.

2 The structures of governance may vary from country to country reflecting cultural and legal backgrounds. Therefore, the respective responsibilities of management and those charged with governance vary depending on the legal responsibilities in the particular jurisdiction.
APPLICABLE FINANCIAL REPORTING FRAMEWORK

2436. The financial reporting framework used by management to prepare the financial statements will depend on the users of these statements and on how their needs are addressed in a particular jurisdiction. In some cases, the financial statements will be intended to meet the common information needs of a wide range of users; in others, they will be intended to meet the specific needs of specifically identified users.

25. Many users rely on financial statements made available by an entity as their major source of financial information about that entity because they do not have the power to obtain additional information to meet their specific needs. While all the information needs of users cannot be met by financial statements made available by an entity, there are needs that are common to all users. As investors are providers of risk capital to the enterprise, it is presumed that financial statements that meet their needs will also meet most of the needs of other users in making economic decisions. As a result, financial statements that are useful to a wide range of users in making economic decisions need to be prepared in accordance with a financial reporting framework that provides information about the financial position, financial performance and cash flows of an entity. Such financial statements are referred to as general purpose financial statements. [Source: IAS Framework, paragraphs 10, 11]

37. Many users of financial statements are not in a position to demand reports tailored to meet their specific information needs. Financial statements that are intended to meet the common information needs of that wide range of users are referred to as general purpose financial statements. While all the information needs of specific users cannot be met by the general purpose financial statements made available by an entity, these are needs that are common to all users. In a profit-oriented enterprise, as investors are providers of risk capital to the enterprise, it is presumed that financial statements that meet their needs will also meet most of the needs of other users in making economic decisions.

38. The objective of general purpose financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to that wide range of users in making economic decisions.

Acceptable financial reporting frameworks for general purpose financial statements

2639. The following financial reporting frameworks International Financial Reporting Standards or national accounting standards that satisfy the criteria described in paragraphs 29 and 30, are presumed to be acceptable appropriate financial reporting frameworks for general purpose financial statements:

(a) International Financial Reporting Standards (or, in the case of public sector entities other than Government Business Enterprises, International Public Sector Accounting Standards);

(b) Established financial reporting standards in a particular jurisdiction;

7 Refer to “Preface to International Public Sector Accounting Standards” for more information on International Public Sector Accounting Standards.
(c) Other specifically developed financial reporting frameworks provided they are comprehensive and authoritative.

ISA 700 “The Auditor’s Report on Financial Statements” addresses the auditor’s report on such general purpose financial statements.

2740. In special purpose audit engagements, a complete set of financial statements may be prepared using other bases of accounting that are designed to meet other objectives of users. Alternatively, an individual financial statement such as a balance sheet and related notes may also be prepared. The needs of the identified users will determine the applicable financial reporting framework in such circumstances. In such circumstances, the applicable financial reporting framework will depend on the information needs of the identified users. Such circumstances and statements are addressed in ISA 800 “The Auditor’s Report on Special Purpose Audit Engagements”.

International Financial Reporting Standards

2841. Paragraphs 10 to 19 of International Accounting Standard (IAS) 1 (Revised 1997), “Presentation of Financial Statements,” set out the requirements to be met before an entity’s financial statements can be regarded as having been prepared in accordance with International Financial Reporting Standards (also referred to as International Accounting Standards). In particular, paragraph 11 indicates that “financial statements should not be described as complying with International Accounting Standards unless they comply with all the requirements of each applicable standard and each applicable interpretation of the Standing Interpretations Committee.”

National Accounting Standards

2942. Established financial reporting standards in a particular jurisdiction refers to standards issued or adopted by national organizations authorized. National accounting standards refers to financial reporting standards issued or adopted by national organizations authorized, for example, by legislation, to establish such promulgate standards in their jurisdiction through an established process involving deliberation and consultation, or to adopt International Financial Reporting Standards or the financial reporting standards of another authorized national organization. [Source: consistent with AICPA AU 411.05]

Other specifically developed financial reporting frameworks provided they are comprehensive and authoritative

3043. Specifically developed financial reporting frameworks may be acceptable in For jurisdictions that do not require the use of standards such as International Financial Reporting Standards or that do not have established financial reporting standards provided they are comprehensive and authoritative.

44. have such organizations, national accounting standards can also refer to financial reporting frameworks that are both comprehensive and authoritative. In such circumstance, a

8 On May 15, 2002, the International Accounting Standards Board issued an exposure draft of improvements to IASs, including an exposure draft of a proposed revised IAS 1. In that exposure draft, the relevant paragraphs are paragraphs 10-17, with paragraph 11 requiring compliance with all applicable standards.

9 The Standing Interpretations Committee was renamed the “International Financial Reporting Interpretations Committee” subsequent to the issue of IAS 1 (Revised 1997).
specifically developed financial reporting framework would be considered to be comprehensive when it results in financial statements that are:

(a) Relevant to the common information needs of a wide range of users in making economic decisions in that they are designed to result in financial statements that will help users make economic decisions by presenting fairly the financial position, financial performance and cash flows of an entity;

(b) Complete in that relevant factors that could affect the fair presentation of the financial position, financial performance and cash flows of the financial statements are not omitted.

(c) Reliable in that it:

(i) reflects the economic substance of events and transactions and not merely their legal form; and

(ii) results in reasonably consistent evaluation, measurement, presentation and disclosure, when used in similar circumstances;

(e) Neutral in that it is free from bias; and

(f) Understandable in that it is clear and comprehensive and not subject to significantly different interpretation.

(i) represent faithfully the results and financial position of the entity;

(ii) reflect the economic substance of events and transactions and not merely the legal form;

(iii) are neutral, that is free from bias;

(iv) are prudent;

(v) are complete in all material respects; and

(c) Provide sufficient disclosures to enable users to understand the impact of particular transactions or events on the entity’s financial positions and financial performance.

[Source for (a) to (c): adapted from IAS 1.15 and .20]

45. A specifically developed financial reporting framework would be considered to be authoritative when it represents prevalent practice in a particular jurisdiction or industry. A conglomeration of accounting conventions devised to suit individual preferences would not be considered to be a comprehensive and authoritative financial reporting framework.  [Source: 1st sentence consistent with AICPA AU 411.05, 2nd sentence from ISA 800.09]

Identification of Applicable Financial Reporting Framework for General Purpose Financial Statements

3446. The legislative and regulatory obligations of the entity will ordinarily often determines the financial reporting framework to be used by management in preparing the entity’s general purpose financial statements, hereinafter referred to as the applicable financial reporting framework.

3247. In addition to specifying the financial reporting framework with which general purpose financial statements are to be prepared, legislation in some jurisdictions sometimes also requires financial statements to comply with certain specified requirements. In these jurisdictions, the applicable financial reporting framework encompasses both the financial reporting framework and the additional requirements specified in legislation.
When the entity is registered or operating in a jurisdiction where there are no such legislative and regulatory obligations, the entity identifies an applicable framework. The entity’s choice will be governed by local practice, industry practice, user needs, or other factors. For example, the entity’s competitors may apply International Financial Reporting Standards and the entity may determine that International Financial Reporting Standards are also appropriate for its financial reporting requirements. [Source for 31 to 33: Adapted from Audit Risk ED—Understanding document, paragraph 30]