PRELIMINARY MARK-UP OF ISA 200

(As agreed at the June IAASB meeting, ISA 200 should be maintained as a ‘moving draft’ throughout the clarity improvement process until towards the end of the project. The purpose of this Agenda Item is therefore to show, for reference purposes, where material from other redrafted ISAs or the Preface may be positioned within this ISA.

Changes have not been proposed in this preliminary draft for restructuring and redrafting, including consideration of the present tense and the introduction of any new ‘principles.’)

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. It also describes management’s responsibility for the preparation and presentation of the financial statements and for identifying the financial reporting framework to be used in preparing the financial statements, referred to in the ISAs as the “applicable financial reporting framework.”

Objective of an Audit of Financial Statements

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.

3. An audit of financial statements is an assurance engagement, as defined in the International Framework for Assurance Engagements. The Framework defines and describes the elements and objectives of an assurance engagement. The ISAs apply the Framework in the context of an audit of financial statements and contain the basic principles and essential procedures, together with related guidance, to be applied in such an audit. Paragraphs 34-35 in this ISA discuss the meaning of the term “financial statements” and management’s responsibility for such statements. As discussed in the Framework, a condition for acceptance of an assurance engagement is that the criteria referred to in the definition are “suitable criteria” and available to intended users. Paragraphs 37-48 in this ISA discuss suitable criteria and their availability to intended users for an audit of financial statements through the auditor’s consideration of the acceptability of the financial reporting framework.

[Note: paragraphs 4-5 repositioned below]

Conduct of an Audit of Financial Statements

6. The auditor shall conduct an audit in accordance with International Standards on Auditing.

ISAs [Issued/Effective] before [date]

7. ISAs contain basic principles and essential procedures (identified in bold type lettering and by use of the word “shall”) 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 ISA Standard is considered in order to understand and apply the basic principles and essential procedures.

7.1 The basic principles and essential procedures of an ISA are designed to be applied in all cases when they are relevant to the circumstance of the audit. A basic principle or essential procedure is relevant when the circumstances envisaged in the specified basic principle or essential procedure exist. In exceptional circumstances, however, the auditor may judge it necessary to depart from a basic principle or essential procedure to achieve the objective(s) of the basic principle or essential procedures. Such exceptional circumstances, if any, are expected to exist only where the basic principle or essential procedure requires a specific procedure to be performed. When such a situation arises, the auditor shall document why the auditor decided to depart and how the alternative procedure(s) performed in the circumstances achieved the objective(s).

ISAs [Issued/Effective] after [date]

7.2 ISAs [issued/effective] after [date] contain objectives and requirements together with related guidance in the form of application material, including appendices. The auditor is required to consider the entire text of an ISA in carrying out work on an audit engagement.

7.3 The auditor is required to meet the objective(s) stated in an ISA by complying with the requirements of the ISA, and by performing procedures that, in the auditor’s judgment and based on the ISA, are deemed appropriate in the particular circumstances. Where applicable, however, the stated objective(s) in a particular ISA will make it clear that any specified procedures represent the full extent of what the auditor is required to do.

7.4 The requirements of an ISA are designed to assist the auditor in meeting the objective(s) specified in that ISA. An individual requirement, however, is normally intended to achieve a more limited purpose, which is referred to below as ‘the objective(s) of the requirement’. In most cases, the objective(s) of a requirement is clear, within the context of the objective(s) specified in an ISA. Where that is not the case, a further description of the purpose of the individual requirement is given.

7.5 The requirements are contained in a separate section of each ISA. They are identified by the use of the word “shall.” If an ISA provides that a procedure or action is one that the auditor “shall consider,” the consideration of the procedure or action is required, while carrying out the procedure or action is not. The requirements are to be understood and applied in the context of the stated objectives and the application material that provides guidance for their application.

7.6 The requirements of an ISA are designed to be applied in all cases when they are relevant to the circumstances of the audit. Requirements are relevant when the circumstances envisaged in the specified requirement exist. In exceptional circumstances, however, the auditor may judge it necessary to depart from a requirement of an ISA to achieve the objective(s) of the requirement. Such exceptional circumstances, if any, are expected to exist only with respect to requirements to perform a specific procedure. When such a situation arises, the auditor shall document why the auditor decided to depart and how the alternative procedure(s) performed in the circumstances achieved the objective(s) of the requirement.

7.7 The application material contained in ISAs is intended to provide further explanation and guidance on the requirements, and may identify and describe other procedures or actions.
relating to the activities of the auditor. While the auditor has a responsibility to consider the whole text of an ISA in carrying out the audit, such guidance is not intended to impose a requirement for the auditor to perform the suggested procedures or actions. Rather, these procedures or actions require the auditor’s attention and understanding; how and whether the auditor carries out such procedures or actions in the engagement will depend on the exercise of professional judgment in the circumstances consistent with the objective stated in the ISA.

7.8 Appendices, which form part of the application material, are an integral part of an ISA. The purpose and intended use of an appendix are clearly explained in the body of the related ISA or within the title and introduction of the appendix itself. The use of appendices may vary depending on the subject of the ISA. [Source: Proposed revised Preface, which would be essentially the same as the above and therefore not produced for purposes of the IAASB meeting.]

8. In conducting an audit in accordance with ISAs, the auditor is also aware of and considers International Auditing Practice Statements (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 ISA[Standard, for ISAs [issued/effective] before [date]]; or
- the requirements in the ISA, for ISAs [issued/effective] after [date]

addressed by the IAPS have been complied with.

9. The auditor may also conduct the audit in accordance with both ISAs and auditing standards of a specific jurisdiction or country.

9.1 The nature of the ISAs requires the auditor to exercise professional judgment in applying them. Any limitation of the applicability of a specific ISA is made clear in the ISA.

Scope of an Audit of Financial Statements

10. The term “scope of an audit” refers to the audit procedures that, in the auditor’s judgment and based on the ISAs, are deemed appropriate in the circumstances to achieve the objective of the audit.

11. In determining the audit procedures to be performed in conducting an audit in accordance with International Standards on Auditing, the auditor shall comply with each of the International Standards on Auditing relevant to the audit. [Note to IAASB: This requirement may no longer be necessary in light of paragraphs 6, 7.1 and 7.5 above. For further consideration when ISA 200 is revised.]

12. In performing an audit, auditors may be required to comply with other professional, legal or regulatory requirements in addition to the ISAs. The ISAs do not override the local laws and regulations that govern an audit of financial statements. In the event that 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.
13. When the auditor conducts the audit in accordance with ISAs and auditing standards of a specific jurisdiction or country, in addition to complying with each of the ISAs relevant to the audit, the auditor also performs any additional audit procedures necessary to comply with the relevant standards of that jurisdiction or country.

13.1 Irrespective of whether an audit is being conducted in the private or public sector, the basic principles of auditing remain the same. What may differ for audits carried out in the public sector is the audit objective and scope. These factors are often attributable to differences in the audit mandate and legal requirements or the form of reporting (for example, public sector entities may be required to prepared additional financial reports).

13.2 When carrying out audits of public sector entities, the auditor will need to take into account the specific requirements of any other relevant regulations, ordinances or ministerial directives which affect the audit mandate and any special auditing requirements, including the need to have regard to issues of national security. Audit mandates may be more specific than those in the private sector, and often encompass a wider range of objectives and a broader scope than is ordinarily applicable for the audit of private sector financial statements. The mandates and requirements may also affect, for example, the extent of the auditor’s discretion in establishing materiality, in reporting fraud and error, and in the form of the auditor’s report. Differences in audit approach and style may also exist. However, these differences would not constitute a difference in the basic principles and essential procedures. [Source: The PSP at the end of this ISA. Similar statements included as PSPs in individual ISAs are to be deleted].

14. The auditor shall not represent compliance with International Standards on Auditing unless the auditor has complied fully with all of the International Standards on Auditing relevant to the audit.

**General Principles Governing An Audit of Financial Statements.**

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

14.14 The auditor shall comply with relevant ethical requirements relating to audit engagements.

14.25 As discussed in ISA 220, “Quality Control for Audits of Historical Financial Information,” ethical requirements relating to audits of financial statements ordinarily comprise Parts A and B of the International Federation of Accountants’ Code of Ethics for Professional Accountants (IFAC Code) together with national requirements that are more restrictive. ISA 220 identifies the fundamental principles of professional ethics established by Parts A and B of the IFAC Code and sets out the engagement partner’s responsibilities with respect to ethical requirements. ISA 220 recognizes that the engagement team is entitled to rely on a firm’s systems in meeting its responsibilities with respect to quality control procedures applicable to the individual audit engagement (for example, in relation to capabilities and competence of personnel through their recruitment and formal training; independence through the accumulation and communication of relevant independence information; maintenance of client relationships through acceptance and continuance systems; and adherence to regulatory and legal requirements through the monitoring process), unless information provided by the firm or other parties suggests otherwise. Accordingly, International Standard on Quality Control
(ISQC) 1, “Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements,” requires the firm to establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements.

**Professional Skepticism**

15. The auditor **shall** 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 **due to fraud or error**, notwithstanding the auditor’s past experience of the honesty and integrity of the entity’s management and those charged with governance. [*Source: Extant ISA 240.24. Repetition of this material in redrafted ISA 240 is deliberate for purposes of emphasis.]*

16. 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 and responses to inquiries and other information obtained from management and those charged with governance. For example, an attitude of professional skepticism is necessary throughout the audit process for the auditor to reduce the risk of overlooking unusual 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.

16.1. Although the auditor cannot be expected to fully disregard past experience of the honesty and integrity of the entity’s management and those charged with governance, the maintenance of an attitude of professional skepticism is important because there may have been changes in circumstances. With respect to those charged with governance, maintaining an attitude of professional skepticism means that the auditor carefully considers the reasonableness of responses to inquiries of those charged with governance, and other information obtained from them, in light of all other evidence obtained during the audit. [*Source: Extant ISA 240.25. This paragraph is general in nature and not solely applicable to fraud.*]

16.2. Accordingly, when making inquiries and performing other audit procedures, the auditor is not satisfied with less-than-persuasive audit evidence based on a belief that management and those charged with governance are honest and have integrity. **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 auditor’s opinion.**

**Reasonable Assurance**

17. An auditor conducting an audit in accordance with ISAs obtains reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether due to fraud or error. 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. An auditor cannot obtain absolute assurance because 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 following:
The use of testing.

The inherent limitations of internal control (for example, the possibility of management override or collusion).

The fact that most audit evidence is persuasive rather than conclusive.

18.1 In addition, because the auditor works within economic limits, principally in relation to forming an audit opinion within a reasonable period of time and at a reasonable cost, the auditor is generally not expected to address all information that may exist. The auditor considers the relationship between the cost of obtaining audit evidence and the usefulness of the information obtained. The matter of difficulty or expense involved, however, is not in itself a valid basis for omitting an audit procedure for which there is no alternative. [Source: Staff drafting (re: first part of first sentence) and extant ISA 500.3, 500.13, and 500.14. An alternative may be to present “cost/benefit considerations” as a principle; the above presentation however may prove less controversial.]

19. Also, the work undertaken by the auditor to form an audit 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 assertions (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, because of the factors described above, an audit is not a guarantee that the financial statements are free from material misstatement, because absolute assurance is not attainable. Consequently, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with ISAs. [Source: Extant ISA 240.17. This paragraph is general in nature and not applicable solely to fraud.] Further, an audit opinion does not assure the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity.

21.1 The subsequent discovery of a material misstatement of the financial statements resulting from fraud does not, in and of itself, indicate a failure to comply with ISAs. This is particularly the case for certain kinds of intentional misstatements, since audit procedures may be ineffective for detecting an intentional misstatement that is concealed through collusion between or among one or more individuals among management, those charged with governance, employees, or
third parties, or that involves falsified documentation. Whether the auditor has performed an audit in accordance with ISAs 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. [Source: Extant ISA 240.20. Relevant to the discussion of reasonable assurance/ inherent limitations of an audit in ISA 200. This placement, in addition to ISA 240, may also give the material more prominence.]

Misstatements

21.2 Misstatements in the financial statements can arise from fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.

21.3 The term “error” refers to an unintentional misstatement in financial statements, including the omission of an amount or a disclosure, such as:

- A mistake in gathering or processing data from which financial statements are prepared.
- An incorrect accounting estimate arising from oversight or misinterpretation of facts
- A mistake in the application of accounting principles relating to measurement, recognition, classification, presentation or disclosure.

21.4 The term “fraud” refers to an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage. Although fraud is a broad legal concept, for the purposes of the ISAs, the auditor is concerned with fraud that causes a material misstatement in the financial statements. Auditors do not make legal determinations of whether fraud has actually occurred. [Source: ISA 240.4-240.7. Placement in ISA 200 allows for discussion of these concepts in relation to the statement in ISA 200.17 (re: to obtain reasonable assurance that…are free from material misstatement, whether due to fraud or error). This guidance is also relevant as context to the discussion of audit risk and materiality that follows below. Repetition of this material in redrafted ISA 240 is deliberate for purposes of emphasis.]

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 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.

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.”
24. The auditor shall 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.

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 315 [Redrafted], “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement” and ISA 330 [Redrafted], “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 500 [Redrafted], “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 the risk of material misstatement 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. The auditor seeks to obtain sufficient appropriate audit evidence 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.

28.1 The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting a material misstatement resulting from error because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. The auditor’s ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error.

28.2 Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records and present fraudulent financial information. Certain levels of management may be in a position to override control procedures designed to prevent similar frauds by other employees, for example, by directing subordinates to record transactions incorrectly or to conceal them. Given its position of authority within an entity, management has the ability to either direct employees to do something or solicit their help to assist in carrying out a fraud, with or without the employees’ knowledge. [Source: ISA 240.18-240.19. Relevant to the discussion of audit risk.]

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. When the auditor’s assessment of the risk of material misstatement includes an expectation of the operating effectiveness of controls, the auditor performs tests of controls to support the risk assessment. 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.

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 factors. Such other factors include the possibility that an auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results. These other factors ordinarily can be addressed 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.

[There are no proposed changes to extant paragraphs 33-52. They have therefore not been reproduced for purposes of the September IAASB meeting.]