# PROPOSED INTERNATIONAL STANDARD ON AUDITING 200

(REVISED AND REDRAFTED) *(Marked from March 2008 IAASB Meeting)*

OVERALL OBJECTIVES OF THE INDEPENDENT AUDITOR AND THE CONDUCT OF AN AUDIT IN ACCORDANCE WITH INTERNATIONAL STANDARDS ON AUDITING

(Effective for audits of financial statements for periods beginning on or after December 15, 2009.)

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Exhibit I: Proposed Conforming Amendments to Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services

Exhibit II: Proposed Conforming Amendments to Final Clarified ISAs
Introduction

Scope of this ISA

1. This International Standard on Auditing (ISA) establishes the independent auditor’s overall responsibilities when conducting an audit of financial statements in accordance with ISAs. Specifically, it sets out the overall objectives of the independent auditor, and explains the nature and scope of an audit designed to enable the independent auditor to meet those objectives. It also explains the scope, authority and structure of the ISAs, and includes requirements establishing the general responsibilities of the independent auditor applicable in all audits, including the obligation to comply with the ISAs. The independent auditor is referred to as “the auditor” hereafter and in the ISAs unless the context requires emphasis of independence.

2. ISAs are written in the context of an audit of financial statements by an auditor. They are to be adapted as necessary in the circumstances when applied to audits of other historical financial information.

An Audit of Financial Statements

3. The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the independent auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general purpose frameworks, that opinion is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view or are presented fairly, in all material respects, in accordance with the framework. An audit conducted in accordance with ISAs and relevant ethical and professional requirements enables the auditor to form that opinion. (Ref: Para. A1) [See A.1 – Agenda Item 4]

4. The financial statements subject to audit are those of the entity, prepared and presented by management of the entity with, where applicable, oversight from those charged with governance. ISAs do not impose responsibilities on management or those charged with governance and do not override laws and regulations that govern their responsibilities. However, an audit in accordance with ISAs is conducted on the premise that management and, where appropriate, those charged with governance have responsibilities that are fundamental to the conduct of the audit. The audit of the financial statements does not relieve management or those charged with governance of those responsibilities. (Ref: Para. A2-A11)

5. As the basis for the auditor’s opinion, ISAs require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a high, but not absolute, level of assurance, because of the inherent limitations of an audit. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. However, reasonable assurance is not an absolute level of assurance, because there are inherent limitations of an audit which result in most of the
audit evidence on which the auditor draws conclusions and bases the auditor’s opinion being persuasive rather than conclusive. (Ref: Para. A27-A51) [See A.2 – Agenda Item 4]

6. The concept of materiality is applied by the auditor used both in planning and performing the audit, and in evaluating the effects of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and the opinion in the auditor’s report. In general, misstatements, including omissions, are considered to be material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. Judgments about materiality are made in the light of surrounding circumstances, and are affected by the auditor’s perception of the financial information needs of users of the financial statements, and by the size or nature of a misstatement, or a combination of both. The auditor’s opinion deals with the financial statements taken as a whole and therefore the auditor is not responsible for the detection of misstatements that are not material to the financial statements taken as a whole.

7. The ISAs require the auditor to obtain reasonable assurance, and contain objectives, requirements and application and other explanatory material that are designed to support the auditor in obtaining reasonable assurance doing so. They ISAs require that the auditor exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit and, amongst other things:

- Identify and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity’s internal control.
- Obtain sufficient appropriate audit evidence about whether the assessed risks have given rise to material misstatements, through designing and implementing appropriate responses to those risks.
- Evaluate the effects of identified misstatements in the financial statements.
- Form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained.

8. Based on the conclusions drawn from the audit evidence about whether reasonable assurance has been obtained and the financial statements as a whole are free from material misstatement, the auditor expresses an opinion on the financial statements. The form of opinion expressed by the auditor will depend upon the applicable financial reporting framework and any applicable laws or regulations. Unless specifically stated otherwise, references in the ISAs to the auditor’s opinion covers both opinions on whether the financial statements give a true and fair view, or are presented fairly, in all material respects, or give a true and fair view, and opinions on compliance with the specific requirements of the applicable financial reporting framework. (Ref: Para. A12)

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9. The auditor may also have certain other communication and reporting responsibilities to users, management, those charged with governance, or parties outside the entity, in relation to matters arising from the audit. These may be established by the ISAs or by applicable laws or regulations.\(^2\) The ISAs also require the auditor to include clear additional communication in the auditor’s report when, in the auditor’s judgment, such communication is appropriate to draw users’ attention to matters which may be relevant to their understanding of the financial statements or the audit. [See A.2 – Agenda Item 4]

10. The auditor’s reporting responsibilities also include communicating relevant audit matters with management and those charged with governance. In certain circumstances, the auditor may have a responsibility to report to third parties.

Effective Date

104. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2009.

Overall Objectives of the Independent Auditor

112. In conducting an audit of financial statements, the overall objectives of the independent auditor are:

   (a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and

   (b) To report on the financial statements, or otherwise as required by the ISAs, in accordance with the auditor’s findings.

123. In all cases when reasonable assurance cannot be obtained and a qualified opinion in the auditor’s report is insufficient in the circumstances for purposes of reporting to the intended users of the financial statements, the ISAs require that the auditor disclaims an opinion or withdraws from the engagement, where withdrawal is legally permitted.

Definitions

143. For purposes of the ISAs, the following terms have the meanings attributed below:

   (a) Applicable financial reporting framework – The financial reporting framework adopted by management and, where appropriate, those charged with governance in the preparation and presentation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation.

\(^2\) See, for example, ISA 260 (Revised and Redrafted), “Communication with Those Charged with Governance,” and ISA 240 (Redrafted), “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements,” paragraph 43.
For purposes of the ISAs, the term “fair presentation framework” is used to refer to a financial reporting framework that requires compliance with the specific requirements of the framework and:

(i) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the specific requirements of the framework; or

(ii) Acknowledges explicitly that, in extremely rare circumstances, it may be necessary for management to depart from a specific requirement of the framework to achieve fair presentation of the financial statements.

The term “compliance framework” is used to refer to a financial reporting framework that requires compliance with the specific requirements of the framework, but does not contain the acknowledgements in (i) or (ii) above.

(b) Audit evidence – All of the information used by the auditor in arriving at the conclusions on which the auditor’s opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information. For purposes of the ISAs:

(i) Sufficiency of audit evidence is the measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor’s assessment of the risks of material misstatement and also by the quality of such audit evidence.

(ii) Appropriateness of audit evidence is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor’s opinion is based.

The sufficiency and appropriateness of audit evidence are interrelated.

(c) Audit risk – The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk.

(d) Auditor – The person or persons conducting the audit, usually the engagement partner and engagement team, and in some cases, the firm. The engagement partner. The term “auditor” is used to describe either the engagement partner or the audit firm. Where it applies to the engagement partner, it describes the obligations or responsibilities of the engagement partner. Such obligations or responsibilities may be fulfilled by either the engagement partner or a member of the audit team. Where an ISA expressly intends that a requirement the obligation or responsibility be fulfilled by the engagement partner, the term “engagement partner” rather than “auditor” is used. [See B.1 – Agenda Item 4]

(e) Detection risk – The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.
(f) Financial statements – A structured representation of historical financial information, including any related explanatory notes, intended to communicate an entity’s economic resources or obligations at a point in time or the changes therein for a period of time in accordance with a financial reporting framework. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information. The term “financial statements” ordinarily refers to a complete set of financial statements as determined by the requirements of the applicable financial reporting framework, but can also refer to a single financial statement.

(g) Historical financial information – Information expressed in financial terms in relation to a particular entity, derived primarily from that entity’s accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.

(h) Management – The person(s) with executive responsibility for the conduct of the entity’s operations. For some entities in some jurisdictions, management includes some or all of those charged with governance, for example, executive members of a governance board, or an owner-manager.

(i) Misstatement – A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud. When the auditor expresses an opinion on whether the financial statements give a true and fair view or are presented fairly, in all material respects, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor’s judgment, are necessary for the financial statements to give a true and fair view or be presented fairly, in all material respects.

(j) Premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit is conducted – That management and, where appropriate, those charged with governance have the following responsibilities that are fundamental to the conduct of an audit in accordance with ISAs. That is, responsibility:

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

(ii) To provide the auditor with:

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

b. Any additional information that the auditor may request from management and, where appropriate, those charged with governance; and
c. Unrestricted access to those within the entity from whom the auditor determines it necessary to obtain audit evidence.

In the case of a fair presentation framework, the responsibility is for the preparation and fair presentation of the financial statements in accordance with the financial reporting framework; or the preparation of financial statements that give a true and fair view in accordance with the financial reporting framework. This applies to all references to “preparation and presentation of the financial statements” in the ISAs.

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

(k) Professional judgment – The application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement.

(l) Professional skepticism – An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

(m) Reasonable assurance – In the context of an audit of financial statements, a high, but not absolute, level of assurance.

(n) Risk of material misstatement – The risk that the financial statements are materially misstated prior to audit. This consists of two components, described as follows at the assertion level:

(i) Inherent risk – The susceptibility of an account balance, class of transaction, or disclosure assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

(ii) Control risk – The risk that a misstatement that could occur in an account balance, class of transaction, or disclosure 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.

(o) Those charged with governance – The person(s) or organization(s) (e.g., a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities in some jurisdictions, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager.
Requirements

Ethical Requirements Relating to an Audit of Financial Statements

145. The auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. (Ref: Para. A13-A16) [See C.1 – Agenda Item 4]

Professional Skepticism

156. The auditor shall plan and perform an audit with professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated. (Ref: Para. A17-A21)

Professional Judgment

168. The auditor shall exercise professional judgment in planning and performing an audit of financial statements in accordance with ISAs. (Ref: Para. A22-A26)

Sufficient Appropriate Audit Evidence and Audit Risk

17. To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence in order to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor’s opinion. (Ref: Para. A27-A51)

Conduct of an Audit in Accordance with ISAs

Complying with ISAs Relevant to the Audit

189. The auditor shall comply with all ISAs relevant to the audit. An ISA is relevant to the audit when the ISA is in effect and the circumstances addressed by the ISA exist. (Ref: Para. A52-A56)

1920. The auditor shall read and understand the entire text of an ISA to understand its objective and to apply its requirements properly. (Ref: Para. A57-A65) [See C.2 – Agenda Item 4]

204. The auditor shall not represent compliance with ISAs in the auditor’s report unless the auditor has complied with the requirements of this ISA and all other ISAs relevant to the audit.

Objectives Stated in Individual ISAs

212. To achieve the overall objectives of the auditor, in planning and performing the audit, and having regard to the interrelationships amongst the ISAs, the auditor shall use the objectives stated in relevant ISAs in planning and performing the audit, having regard to the interrelationships among the ISAs, to: (Ref: Para. A66-A68) [See C.3 – Agenda Item 4]

(a) Determine whether any audit procedures in additional to those required by the ISAs that are necessary to be performed in pursuance of the objectives stated in the ISAs; and (Ref: Para. A69)

(b) Evaluate whether sufficient appropriate audit evidence has been obtained in the context of the overall objectives of the auditor. (Ref: Para. A70)
Complying with Relevant Requirements

223. Subject to paragraph 234, the auditor shall comply with each requirement of an ISA unless, in the circumstances of the audit:

(a) The entire ISA is not relevant; or
(b) The requirement is not relevant because it is conditional and the condition does not exist. (Ref: Para. A71-A72)

234. In exceptional circumstances, the auditor may judge it necessary to depart from a relevant requirement in an ISA. In such circumstances, the auditor shall perform alternative audit procedures to achieve the aim of that requirement. The need for the auditor to depart from a relevant requirement is expected to arise only where the requirement is for a specific procedure to be performed and, in the specific circumstances of the audit, that procedure would be ineffective in achieving the aim of the requirement. (Ref: Para. A73)

Failure to Achieve an Objective

245. If an objective in a relevant ISA cannot be achieved, the auditor shall evaluate whether this prevents the auditor from achieving the overall objectives of the auditor, thereby requiring the auditor, in accordance with the ISAs, to modify the auditor’s opinion or withdraw from the engagement. Failure to achieve an objective represents a significant matter requiring documentation in accordance with ISA 230 (Redrafted) 3. (Ref: Para. A74-A75) [See C.3 – Agenda Item 4]

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Application and Other Explanatory Material

An Audit of Financial Statements

Scope of the Audit-Opinion (Ref: Para. 3)

A1. The scope of the opinion expressed by the auditor will depend upon any applicable laws and regulations. The auditor’s opinion on the financial statements deals with whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. Such an opinion is common to all audits of financial statements. The auditor’s opinion therefore does not assure, for example, the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity. Absent any specific laws or regulations that require otherwise, an audit does not lead to the expression of an opinion on matters such as whether future events or conditions may cause an entity to be unable to continue as a going concern, or on the efficiency or effectiveness with which management has conducted the affairs of the entity, including the effectiveness of internal control. However, in some jurisdictions, however, applicable laws and regulations may require auditors to provide opinions on other specific matters, such as the effectiveness of internal control, or the consistency of a separate management report with the financial statements. While the ISAs include requirements and guidance in relation to such matters to the extent that they are relevant to

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3 ISA 230 (Redrafted), “Audit Documentation,” paragraph 8(c).
forming an opinion on the financial statements, the auditor would be required to undertake further work if the auditor had additional responsibilities to provide such opinions.

**Preparation of the Financial Statements** (Ref: Para. 4)

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

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

(b) To provide the auditor with:

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

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

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

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

- The identification of the applicable financial reporting framework, in the context of any relevant laws or regulations.
- They are also responsible for the preparation and presentation of the financial statements in accordance with that framework.
- An adequate description of that framework in the financial statements.

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

A4. The financial statements may be prepared in accordance with a financial reporting framework designed to meet:

- The common financial information needs of a wide range of users (i.e., “general purpose financial statements”); or
- The financial information needs of specific users (i.e., “special purpose financial statements”).

A5. The applicable financial reporting framework often encompasses financial reporting standards established by an authorized or recognized standards setting organization, or legislative or regulatory requirements. In some cases, the financial reporting framework may encompass both financial reporting standards established by an authorized or recognized standards setting organization and legislative or regulatory requirements. Other sources may
provide direction on the application of the applicable financial reporting framework. In some cases, the applicable financial reporting framework may encompass such other sources, or may even consist only of such sources. Such other sources may include:

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

Where conflicts exist between the financial reporting framework and the sources from which direction on its application may be obtained, or amongst the sources that encompass the financial reporting framework, the source with the highest authority prevails.

A6. The requirements of the applicable financial reporting framework determine the form and content of the financial statements. Although the framework may not specify how to account for or disclose all transactions or events, it ordinarily embodies sufficient broad principles that can serve as a basis for developing and applying accounting policies that are consistent with the concepts underlying the requirements of the framework.

A7. Some financial reporting frameworks are fair presentation frameworks, while others are compliance frameworks. Financial reporting frameworks that encompass primarily the financial reporting standards established by an organization that is authorized or recognized to promulgate standards to be used by entities for preparing and presenting general purpose financial statements are often designed to achieve fair presentation, for example, International Financial Reporting Standards (IFRSs).

A8. The requirements of the applicable financial reporting framework also determine what constitutes a complete set of financial statements. In the case of many frameworks, financial statements are intended to provide information about the financial position, financial performance and cash flows of an entity. For such frameworks, a complete set of financial statements would include a balance sheet; an income statement; a statement of changes in equity; a cash flow statement; and related explanatory notes, comprising a summary of significant accounting policies and other explanatory notes. For some other financial reporting frameworks, a single financial statement and the related explanatory notes might constitute a complete set of financial statements:

- For example, the International Public Sector Accounting Standard (IPSAS), “Financial Reporting Under the Cash Basis of Accounting” states that the primary financial statement is a statement of cash receipts and payments when a public sector entity prepares and presents its financial statements in accordance with that IPSAS.
- Other examples of a single financial statement, each of which would include related explanatory notes, are:
– Balance sheet.
– Statement of income or statement of operations.
– Statement of retained earnings.
– Statement of cash flows.
– Statement of cash receipts and disbursements.
– Statement of assets and liabilities that does not include owner’s equity.
– Statement of changes in owners’ equity.
– Statement of revenue and expenses.
– Statement of operations by product lines.

A9. [Proposed] ISA 210 (Redrafted) establishes requirements and provides guidance on determining the acceptability of the applicable financial reporting framework.4 [Proposed] ISA 800 (Revised and Redrafted) contains additional considerations for special purpose frameworks.5

A10. Because of the significance of the premise to the conduct of an audit, the auditor is required to obtain agreement from management and, where appropriate, those charged with governance that they acknowledge and understand their responsibilities set out in paragraph A2 as a precondition for accepting the audit engagement.6 The auditor is also required to obtain written representations about whether management and, where appropriate, those charged with governance have fulfilled those responsibilities.7

Considerations Specific to Public Sector Entities

A11. The mandates for audits of the financial statements of public sector entities may be broader than those of other entities. As a result, the premise, relating to management’s responsibilities, on which an audit of the financial statements of a public sector entity is conducted may include additional responsibilities, such as the responsibility for the execution of transactions and events in accordance with legislation or proper authority.

Form of the Auditor’s Opinion (Ref: Para. 89)

A12. Where the applicable financial reporting framework is a fair presentation framework, as is generally the case for general purpose financial statements, the opinion required by the ISAs is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view, or are presented fairly, in all material respects – see [proposed] ISA 700 (Redrafted)8.

6  [Proposed] ISA 210 (Redrafted), paragraph [4(b)].
Ethical Requirements Relating to an Audit of Financial Statements (Ref: Para. 14§)

A13. The auditor is subject to relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. Relevant ethical requirements ordinarily comprise Parts A and B of the International Federation of Accountants’ Code of Ethics for Professional Accountants (the IFAC Code) related to an audit of financial statements together with national requirements that are more restrictive.

A14. Part A of the IFAC Code establishes the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements and provides a conceptual framework for applying those principles. The fundamental principles with which the auditor is required to comply by the IFAC Code are:

(a) Integrity;
(b) Objectivity;
(c) Professional competence and due care;
(d) Confidentiality; and
(e) Professional behavior.

Part B of the IFAC Code illustrates how the conceptual framework is to be applied in specific situations.

A15. In the case of an audit engagement it is in the public interest and, therefore, required by the IFAC Code, that the auditor be independent of the entity subject to the audit. The IFAC Code describes independence as comprising both independence of mind and independence in appearance. The auditor’s independence from the entity safeguards the auditor’s ability to form an audit opinion without being affected by influences that might compromise that opinion. Independence enhances the auditor’s ability to act with integrity, to be objective and to maintain an attitude of professional skepticism.

A16. [Proposed] International Standard on Quality Control (ISQC) 1 (Redrafted) sets out the responsibilities of the firm for establishing policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements, including those pertaining to independence.9 [Proposed] ISA 220 (Redrafted) sets out the engagement partner’s responsibilities with respect to relevant ethical requirements. These include evaluating whether members of the engagement team have complied with relevant ethical requirements, determining the appropriate action if matters come to the engagement partner’s attention that indicate that members of the engagement team have not complied with relevant ethical requirements, and forming a conclusion on compliance with independence requirements that apply to the audit engagement.10

applicable to the individual audit engagement, unless information provided by the firm or other parties suggests otherwise. Accordingly, [proposed] International Standard on Quality Control (ISQC) 1 (Redrafted) 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. 11 [See C.1 – Agenda Item 4]

Professional Skepticism (Ref: Para. 156)

A17. Professional skepticism includes being alert to, for example:

- Audit evidence that contradicts other audit evidence obtained.
- Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
- Conditions that may indicate possible fraud.
- Circumstances that suggest the need for audit procedures in addition to those required by the ISAs, for example to address the risk of fraud in the circumstances where fraud risk factors exist and a single document is the sole supporting evidence for a material financial statement amount and is of a nature that is susceptible to fraud.

A18. Maintaining professional skepticism throughout the audit is necessary if the auditor is, for example, to reduce the risks of:

- Overlooking unusual circumstances.
- Overgeneralizing when drawing conclusions from audit observations.
- Using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

A19. Professional skepticism is also necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence that is contradictory and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the adequacy of audit evidence obtained in the light of the circumstances, for example in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.

A20. Although the auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary, an audit ordinarily does not involve specific measures to authenticate documents, and the auditor is neither trained as nor expected to be an expert in such authentication, the auditor is nevertheless required to consider the reliability of information to be used as audit evidence. 12 In cases of doubt about the reliability of information or indications of possible fraud (for example if conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a

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11 [Proposed] International Standard on Quality Control (ISQC) 1 (Redrafted), “Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements.”

document may have been falsified), the ISAs require that the auditor investigate further and determine what modifications to or additions to audit procedures are necessary to resolve the matter.\[^{13}\] Unless as a result of such consideration the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine.

A210. Although the auditor cannot be expected to disregard past experience of the honesty and integrity of the entity’s management and those charged with governance, a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism nor does it allow the auditor to be satisfied with less-than-persuasive audit evidence when obtaining reasonable assurance.

**Professional Judgment** (Ref: Para. 168)

A2248. Professional judgment is essential to the proper conduct of an audit. This is because interpretation of relevant ethical requirements and the ISAs and the informed decisions required throughout the audit cannot be made without the application of relevant knowledge and experience to the facts and circumstances. Professional judgment is necessary in particular regarding decisions about:

- Materiality and audit risk;\[^{2}\]
- The nature, timing, and extent of audit procedures used to meet the requirements of the ISAs and gather audit evidence;\[^{2}\]
- Evaluating whether sufficient appropriate audit evidence has been obtained, and whether more needs to be done to achieve the objectives of the ISAs and thereby, the overall objectives of the auditor.
- The evaluation of management’s judgments in applying the entity’s applicable financial reporting framework;\[^{2}\] and
- The drawing of conclusions based on the audit evidence obtained, for example, assessing the reasonableness of the estimates made by management in preparing the financial statements.

A2349. The distinguishing feature of the professional judgment expected of an auditor is that it is exercised by an auditor whose training, knowledge and experience have assisted in developing the necessary competencies to achieve reasonable consistency of judgment.

A2450. Whether the exercise of professional judgment in any particular case is reasonable is based on the facts and circumstances that were known, or could reasonably be expected to have been known, by the auditor at the time the judgment was made. Consultation on difficult or contentious matters during the course of the audit, both within the engagement team and between the engagement team and others at the appropriate level within or outside

the firm, such as that required by [proposed] ISA 220 (Redrafted)\(^\text{14}\), assist the auditor in making informed and reasonable judgments.

A25. Professional judgment can be evaluated based on what most other experienced auditors, having knowledge of all relevant information, would reasonably conclude to be appropriate, including whether the judgment reached reflects a proper, competent application of auditing and accounting principles and is appropriate in the light of, and consistent with, the facts and circumstances that were known at the time the judgment was made, and the proper, competent application of auditing and accounting principles. Consultation on difficult or contentious matters during the course of the audit, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm, such as that required by [proposed] ISA 220 (Redrafted), assist the auditor in making informed and reasonable judgments.  

\[\text{[See D.1 – Agenda Item 4]}\]

A26. Professional judgment needs not only to be exercised throughout the audit. It but also needs to be appropriately documented evidenced. In this regard, the auditor is required to prepare audit documentation sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the significant professional judgments made in reaching conclusions on significant matters arising during the audit.\(^\text{15}\) Professional judgment is not to be used as the justification for decisions that are not otherwise supported by the facts and circumstances of the engagement or sufficient and appropriate audit evidence.  

\[\text{[See D.1 – Agenda Item 4]}\]

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

A21. The auditor has the overall objective of obtaining reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is obtained when the auditor has reduced audit risk to an acceptably low level. The auditor is required to reduce audit risk by obtaining sufficient appropriate audit evidence. The following provides further discussion of these matters.

** Sufficiency and Appropriateness of Audit Evidence**

A27. Audit evidence is necessary to support the auditor’s opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits (provided the auditor has determined whether changes have occurred since the previous audit that may affect its relevance to the current audit\(^\text{16}\)) or a firm’s quality control procedures for client acceptance and continuance. In addition to other sources inside and outside the entity, the entity’s accounting records are an important source of audit evidence. Also, information that may be used as audit evidence may have been prepared by an expert employed or engaged by the entity. Audit evidence comprises both information that supports and corroborates management’s assertions, and any information that contradicts

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\(14\) [Proposed] ISA 220 (Redrafted), paragraph [18].  
\(15\) ISA 230 (Redrafted), paragraph 8.  
such assertions. In addition, in some cases, the absence, existence of a lack of information, evidence (e.g., for example, management’s refusal, failure to provide a requested representation) is also represents information used by the auditor, and therefore, also constitutes audit evidence. Most of the auditor’s work in forming the auditor’s opinion consists of obtaining and evaluating audit evidence.

A283. Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor’s assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality.

A2924. Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor’s opinion is based. The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.

A3025. The sufficiency and appropriateness of audit evidence are interrelated. Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the auditor’s opinion, is a matter of for the auditor to determine using professional judgment. [Proposed] ISA 500 (Redrafted) and other relevant ISAs establish additional requirements and provide further guidance applicable throughout the audit regarding the auditor’s considerations in obtaining sufficient appropriate audit evidence.

Audit Risk

A3126. Audit risk is a function of the risks of material misstatement and detection risk. The assessment of risks is a matter of professional judgment, based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.

A3227. For purposes of the ISAs, audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not. This risk is ordinarily insignificant. Further, audit risk is a technical term related to the process of auditing; it does not refer to the auditor’s business risks to the auditor and therefore does not include such risks as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements.

Risks of Material Misstatement

A3328. The risks of material misstatement may exist at two levels:

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

A3429. Risks of material misstatement at the overall financial statement level refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.
A350. Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements taken as a whole at an acceptably low level of audit risk. Auditors use various approaches to accomplish the objective of assessing the risks of material misstatement. For example, the auditor may make use of a model that expresses the general relationship of the components of audit risk in mathematical terms to arrive at an acceptable level of detection risk. Some auditors find such a model to be useful when planning audit procedures to achieve a desired audit risk though the use of such a model does not eliminate the judgment inherent in the assessment of risks and generally in the audit process.

A364. The risks of material misstatement at the assertion level consist of two components: inherent risk and control risk. Inherent risk and control risk are the entity’s risks; they exist independently of the audit of the financial statements.

A372. Inherent risk is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, it may be higher for complex calculations or for accounts consisting of amounts derived from accounting estimates that are subject to significant estimation uncertainty. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement. Factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may also influence the inherent risk related to a specific assertion. Such factors may include, for example, a lack of sufficient working capital to continue operations or a declining industry characterized by a large number of business failures.

A383. Control risk is a function of the effectiveness of the design, implementation and maintenance of internal control by management to address identified risks that threaten the achievement of the entity’s objectives relevant to preparation of the entity’s financial statements. However, internal control, no matter how well designed and operated, can only reduce, but not eliminate, risks of material misstatement in the financial statements, because of the inherent limitations of internal control. These include, for example, the possibility of human errors or mistakes, or of controls being circumvented by collusion or inappropriate management override. Accordingly, some control risk will always exist. The ISAs provide the conditions under which the auditor is required to, or may choose to, test the operating effectiveness of controls in determining the extent of substantive procedures to be performed.17

A3934. The ISAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the “risks of material misstatement.” However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in

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.

A40. ISA 315 (Redrafted) establishes requirements and provides guidance on identifying and assessing the risks of material misstatement at the financial statement and assertion levels.

Detection Risk

A41. For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessed risks of material misstatement at the assertion level. For example, the greater the risks of material misstatement the auditor believes exists, the less the detection risk that can be accepted and, accordingly, the more persuasive the audit evidence required by the auditor.

A42. Detection risk relates to the nature, timing, and extent of the auditor’s procedures that are determined by the auditor to reduce audit risk to an acceptably low level. It is therefore a function of the effectiveness of an audit procedure and of its application by the auditor. Matters such as:

- Adequate planning,
- Proper assignment of personnel to the engagement team,
- The application of professional skepticism, and
- Supervision and review of the audit work performed,

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

A43. ISAs 300 (Redrafted) and 330 (Redrafted) establish requirements and provide guidance on planning an audit of financial statements and the auditor’s responses to assessed risks. Detection risk, however, can only be reduced, not eliminated, because of the inherent limitations of an audit. Accordingly, some detection risk will always exist.

Inherent Limitations of an Audit

A44. The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor’s opinion being persuasive rather than conclusive. The principal inherent limitations of an audit arise from:

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

18 ISA 300 (Redrafted), “Planning an Audit of Financial Statements.”
The Nature of Financial Reporting

The preparation of financial statements in accordance with the entity’s applicable financial reporting framework involves judgment by management in applying the requirements of that entity’s applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgments that may be made. Consequently, some financial statement items are subject to an inherent level of variability which cannot be eliminated by the application of additional auditing procedures. For example, this is often the case with respect to certain accounting estimates. Nevertheless, the ISAs require the auditor to give specific consideration to whether accounting estimates are reasonable in the context of the applicable financial reporting framework and to related disclosures, and to the qualitative aspects of the entity’s accounting practices, including indicators of possible bias in management’s judgments. This may be because, for example, the applicable financial reporting framework requires a future event to be estimated (for example, in determining a provision for the costs of unsettled litigation or a claim), or it requires an asset or liability to be measured on the basis of fair value at the date of the financial statements although there may be no transaction by reference to which that measurement may be definitively established. Many such financial statement items involve subjective decisions or assessments or a degree of uncertainty relating to the reliability of their measurement, and there may be a range of acceptable interpretations or judgments that may be made. Accordingly, although the auditor may obtain audit evidence sufficient to determine their true validity until, for example, the outcome of the future events is known.

The Nature of Audit Procedures

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

- There is the possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant to the preparation and presentation of the financial statements or that has been requested by the auditor. Accordingly, the auditor cannot be certain of the completeness of information. Although even though the auditor has can inquire of management and others and performed audit procedures to obtain assurance evidence that all relevant of the information required by the auditor has been obtained, the auditor cannot be certain of the completeness of information in the absence of legal powers of search.

- Fraud may involve sophisticated and carefully organized schemes designed to conceal it. Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation which may cause the auditor to believe that audit evidence is valid when it is not. An audit of financial statements ordinarily does not involve the authentication of

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documents, and the auditor is neither trained as nor expected to be an expert in the authentication of documents (see discussion in paragraph A19).

- An audit is not an investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

Timeliness of Financial Reporting and the Balance between Benefit and Cost

A472. The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive. Further, appropriate planning assists in ensuring that sufficient time and resources are available for the conduct of the audit. Notwithstanding this, however, the relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost. This is recognized in certain financial reporting frameworks (see, for example, the International Accounting Standards Board’s “Framework for the Preparation and Presentation of Financial Statements”).

A48. Therefore, there is therefore an expectation by users of financial statements that the auditor will form an opinion on the financial statements within a reasonable period of time and at a reasonable cost, recognizing that accordingly, the auditor is expected to apply techniques and exercise professional judgment appropriate in the circumstances whilst recognizing that:

- It is impracticable to address all information that may exist or to pursue every matter exhaustively on the assumption that information is in error or fraudulent until proved otherwise.
- The evidence gathering process reaches a point of diminishing returns, at which the incremental cost of additional audit evidence increases disproportionately to the incremental benefit obtained.

A484. Consequently, it is necessary for the auditor to:

- Plan the audit so that it will be performed in an effective manner;
- Direct audit effort to areas most expected to contain risks of material misstatement, whether due to fraud or error, with correspondingly less effort directed at other areas (i.e., to adopt a ‘risk-based approach’ to the audit); and
- Use testing, including sampling, and other means of examining populations for misstatements.

However, an audit that is directed at risks of material misstatement and the inherent nature of testing are such that there is a risk that a material misstatement will not be detected.

A4945. In light of the approaches described in paragraph A48, recognition of these limitations, the ISAs contain requirements for the planning and performance of the audit and require the auditor, amongst other things, to:

- Perform risk assessment procedures and related activities to provide a basis for the identification and assessment of risks of material misstatement at the financial statement
and assertion levels by performing risk assessment procedures and related activities; \(^{20}\) and

- Use testing, including sampling, and other means of examining populations in a manner that provides an appropriate basis for the auditor to draw conclusions about the population. \(^{21}\)

Other Matters that Affect the Inherent Limitations of an Audit

In the case of certain assertions or subject matters, the potential effects of the inherent limitations on the auditor’s ability to detect material misstatements or otherwise obtain conclusive audit evidence are particularly significant. Such assertions or subject matters include:

- Fraud, particularly fraud involving senior management, sophisticated and carefully organized schemes designed to conceal it, or collusion. See ISA 240 (Redrafted) for further discussion.

- The existence and completeness of related party relationships and transactions. See [proposed] ISA 550 (Revised and Redrafted) \(^{22}\) for further discussion.

- The occurrence of non-compliance with laws and regulations, in particular those relating principally to the operating aspects of an entity and which typically do not affect the financial statements and are not captured by the entity’s information systems relevant to financial reporting. See [proposed] ISA 250 (Redrafted) \(^{23}\) for further discussion.

- Future events or conditions that may cause an entity to cease to continue as a going concern. See [proposed] ISA 570 (Redrafted) \(^{24}\) for further discussion.

However, where appropriate, relevant ISAs identify specific audit procedures to assist in mitigating the effect of the inherent limitations. For example, ISA 240 (Redrafted) contains specific requirements designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.

Because of the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with ISAs. Accordingly, the subsequent discovery of a material misstatement of the financial statements resulting from fraud or error does not, in and of itself, by itself indicate a failure to conduct an audit in accordance with ISAs. However, the inherent limitations of an audit are not a justification for the auditor to be satisfied with less-than-persuasive audit evidence. Whether the auditor has performed an audit in accordance with 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 in light of the overall objectives of the auditor.

Conduct of an Audit in Accordance with ISAs

Nature of ISAs (Ref: Para. 189)

A52. ISAs, taken together, provide the standards for the auditor’s work in fulfilling the overall objectives of the auditor. The ISAs deal with the general responsibilities of the auditor, as well as the auditor’s further considerations relevant to the application of those responsibilities to specific topics.

A53. The scope, effective date and any specific limitation of the applicability of a specific ISA is made clear in the ISA. Unless otherwise stated in the ISA, the auditor is permitted to apply an ISA before the effective date specified therein.

A54. In performing an audit, the auditor may be required to comply with other professional, legal or regulatory requirements in addition to the ISAs. The ISAs do not override 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 only in accordance with laws and regulations will not automatically comply with ISAs.

A55. The auditor may also conduct the audit in accordance with both ISAs and auditing standards of a specific jurisdiction or country. In such cases, in addition to complying with each of the ISAs relevant to the audit, it may be necessary for the auditor to perform additional audit procedures in order to comply with the relevant standards of that jurisdiction or country.

Considerations Specific to Audits in the Public Sector

A56. ISAs are relevant to engagements in the public sector. The public sector auditor’s responsibilities, however, may be affected by the audit mandate, or by obligations on public sector entities arising from legislation, regulation, ministerial directives, government policy requirements, or resolutions of the legislature, which may encompass a broader scope than an audit of financial statements in accordance with the ISAs. These additional responsibilities are not dealt with in the ISAs. They may be dealt with in the pronouncements of the International Organization of Supreme Audit Institutions or national standards-setters, or in guidance developed by government audit agencies.

Contents of ISAs (Ref: Para. 1920)

A57. In addition to objectives and requirements (requirements are expressed in the ISAs using “shall”), an ISA contains related guidance in the form of application and other explanatory material. It may also contain introductory material that provides context relevant to a proper understanding of the ISA, and definitions. The entire text of an ISA, therefore, is relevant to an understanding of the objectives stated in an ISA and the proper application of the requirements of an ISA properly, it is necessary for the auditor to read and understand all parts of the text of an ISA. [See C.2 – Agenda Item 4]

A58. Where necessary, the application and other explanatory material provides further explanation of, and guidance for carrying out, the requirements of an ISA and guidance for carrying them out. In particular, it may:
• Explain Define more precisely what a requirement means or is intended to cover.
• Include examples of relevant procedures, many of which the auditor that may judge to be appropriate in the circumstances.

While such guidance does not in itself impose a requirement, it is relevant to the proper application of the requirements of an ISA. The application and other explanatory material may also provide background information on matters addressed in an ISA.

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

Introductory material may include, as needed, such matters as explanation of:
• The purpose and scope of the ISA, including how the ISA relates to other ISAs;
• The subject matter of the ISA;
• The respective responsibilities Specific expectations of the auditor and others in relation to the subject matter of the ISA; and
• The context in which the ISA is set.

An ISA may include, in a separate section under the heading ‘Definitions’, a description of the meanings attributed to certain terms for purposes of the ISAs. These are provided to assist in the consistent application and interpretation of the ISAs, and are not intended to override definitions that may be established for other purposes, whether in law, regulation or otherwise. Unless otherwise indicated, those terms will carry the same meanings throughout the ISAs. The Glossary of Terms relating to International Standards issued by the International Auditing and Assurance Standards Board in the Handbook of International Auditing, Assurance, and Ethics Pronouncements published by IFAC contains a complete listing of terms defined in the ISAs. It also includes descriptions of other terms found in ISAs to assist in common and consistent interpretation and translation.

When appropriate, additional considerations specific to audits of smaller entities and public sector entities are included within the application and other explanatory material of an ISA. These additional considerations assist in the application of the requirements of the ISA in the audit of such entities. They do not, however, limit or reduce the responsibility of the auditor to apply and comply with the requirements of the ISAs. [See D.3 – Agenda Item 4]

Considerations Specific to Smaller Entities

For purposes of specifying additional considerations to audits of smaller entities, a “smaller entity” reflects the size of the entity which typically possesses qualitative characteristics such as:

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

(b) One or more of the following:

(i) Straightforward or uncomplicated transactions; Few sources of income;
(ii) Unsophisticated record-keeping; or
(iii) Few lines of business and few products within business lines;
(iii–iv) Limited internal controls together with the potential for management override of controls;
(v) Few levels of management with responsibility for a broad range of controls; or
(vi) Few personnel, many having a wide range of duties.

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

A64. While some of the considerations specific to smaller entities included in the ISAs may be helpful in audits of smaller listed entities, the considerations have been developed primarily with unlisted entities in mind. A listed entity is unlikely to display the above characteristics because of the wider distribution of share ownership and the need for internal control appropriate to a listed entity. [See D.3 – Agenda Item 4]

A65. In some cases, a smaller entity may be an owner-managed entity. The ISAs refer to the proprietor of an entity who is involved in running the entity on a day-to-day basis as the ‘owner-manager.’

Objectives Stated in Individual ISAs (Ref: Para. 212)

A66. While the ISAs, taken together, are designed to enable the auditor to meet the overall objectives of the auditor, the ISAs cannot anticipate all circumstances that may arise. Each ISA therefore contains one or more objectives or objectives which provide a link between the requirements and the overall objectives of the auditor. The objectives in individual ISAs serve to focus the auditor on the desired outcome of the ISA, while being specific enough to assist the auditor in:

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

A67. Objectives are to be understood in the context of the overall objectives of the auditor stated in paragraph 112 of this ISA. The ability to achieve an individual objective is equally subject to the inherent limitations of an audit. The ability to achieve an individual objective may be limited by circumstances; for example, by a limitation in the available audit evidence. Whether an objective has been, or can be, achieved is a matter for the auditor’s professional judgment, including whether other procedures will assist the auditor in doing so. [See C.3 – Agenda Item 4]

A68. In using the objectives of the ISAs for the purposes described in paragraph 212, the auditor is required to have regard to the interrelationships amongst the ISAs. This is because, as indicated in paragraph A52, the ISAs deal in some cases with general responsibilities and in others with the application of those responsibilities to specific topics. For example, this ISA requires the auditor to adopt an attitude of professional skepticism; this is necessary in all aspects of planning and performing an audit but is not repeated as a requirement of each ISA.
At a more detailed level, ISA 315 (Redrafted) and ISA 330 (Redrafted) contain, amongst other things, objectives and requirements that deal with the auditor’s responsibilities to identify and assess the risks of material misstatement and to design and perform further audit procedures to respond to those assessed risks, respectively; these objectives and requirements apply throughout the audit. An ISA dealing with specific aspects of the audit (for example, ISA 540 (Revised and Redrafted)) may expand on how the objectives and requirements of such ISAs as ISA 315 (Redrafted) and ISA 330 (Redrafted) are to be applied in relation to the subject of the ISA but does not repeat them. Thus, in achieving the objective stated in ISA 540 (Revised and Redrafted), the auditor has regard to the objectives and requirements of other relevant ISAs.

Use of Objectives to Determine Need for Additional Audit Procedures (Ref: Para. 212(a))

A69. The requirements of the ISAs are designed to enable the auditor to achieve the objectives specified in the ISAs, and thereby the overall objectives of the auditor. The proper application of the requirements of the ISAs by the auditor is therefore expected to provide a sufficient basis for the auditor’s achievement of the objectives. However, because the circumstances of audit engagements vary widely and all such circumstances cannot be anticipated in the ISAs, the auditor is responsible for determining the audit procedures necessary to fulfill the requirements of the ISAs and to achieve the objectives. In the circumstances of an engagement, there may be particular matters that require the auditor to consider further the audit procedures necessary to meet the objectives specified in the ISAs. Accordingly, the auditor is required by paragraph 212(a) to use the objectives in each relevant ISA to determine whether any audit procedures additional to those required by the ISA are necessary in pursuance of those objectives. [See C.3 – Agenda Item 4]

Use of Objectives to Evaluate Whether Sufficient Appropriate Audit Evidence Has Been Obtained (Ref: Para. 212(b))

A70. The auditor is required to use the objectives to evaluate whether sufficient appropriate audit evidence has been obtained in the context of the overall objectives of the auditor. If as a result the auditor concludes that the audit evidence is not sufficient and appropriate, then the auditor may follow one or more of the following approaches to meeting the requirement of paragraph 212(b):

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

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

ISA 540 (Revised and Redrafted), “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures.”
Complying with Relevant Requirements

Relevant Requirements (Ref: Para. 223)

A71. In some cases, an ISA (and therefore all of its requirements) may not be relevant in the circumstances. For example, if an entity does not have an internal audit function in a continuing engagement, nothing in [proposed] ISA 6510 (Redrafted) is relevant. [Similarly, [proposed] ISA 800 (Revised and Redrafted), which deals with special considerations relevant to an audit of special purpose financial statements and an audit of a specific element, account or item of a financial statement, would not be relevant to an audit of general purpose financial statements.]

A72. Within a relevant ISA, there may be conditional requirements. Such a requirement is relevant when the circumstances envisioned in the requirement apply and the condition exists. In general, the any-conditionality of a requirement will either be explicit or implicit, for example:

• The requirement to modify the auditor’s opinion if there is a limitation of scope represents an explicit conditional requirement.

• The requirement to communicate significant deficiencies in internal control identified during the audit to those charged with governance, which depends on the existence of such identified significant deficiencies; and the requirement to obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework, which depends on that framework requiring or permitting such disclosure, represent implicit conditional requirements.

Departure from a Requirement (Ref: Para. 234)

A73. ISA 230 (Redrafted) establishes documentation requirements in those exceptional circumstances where the auditor departs from a relevant requirement. The omission of a requirement that is not relevant in the circumstances of the audit; this does not constitute a departure from the requirement.

Failure to Achieve an Objective (Ref: Para. 245) [See C.3 – Agenda Item 4]

A74. Whether an objective has been achieved is a matter for the auditor’s professional judgment. That judgment takes account of the results of audit procedures performed in complying with the requirements of the ISAs, and the auditor’s evaluation of whether sufficient appropriate audit evidence has been obtained and whether more needs to be done in the particular

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26 [Proposed] ISA 6510 (Redrafted), “[Using the Work of Internal Auditors] Initial Audit Engagements – Opening Balances.”


30 ISA 230 (Redrafted), paragraph 12.
circumstances of the audit to achieve the objectives stated in the ISAs. Accordingly, circumstances that may give rise to a failure to achieve an objective include those that:

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

Such circumstances may prevent the auditor from achieving either of the overall objectives of the auditor, representing compliance with ISAs, or completing the engagement.

A75. Audit documentation that meets the requirements of ISA 230 (Redrafted) and the specific documentation requirements of other relevant ISAs provides evidence of the auditor’s basis for a conclusion about the achievement of the overall objectives of the auditor. While it is unnecessary for the auditor to document separately (as in a checklist, for example) that individual objectives have been achieved, the documentation of a failure to achieve an objective assists the auditor’s evaluation of whether such a failure has prevented the auditor from achieving the overall objectives of the auditor.
Exhibit I

Proposed Conforming Amendments to Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services (Preface)

[There are no changes proposed to paragraphs 1-3. Accordingly, they are not reproduced.]

The Authority Attaching to International Standards Issued by the International Auditing and Assurance Standards Board

4. International Standards on Auditing (ISAs) are to be applied in the audit of historical financial information.

5. International Standards on Review Engagements (ISREs) are to be applied in the review of historical financial information.

6. International Standards on Assurance Engagements (ISAEs) are to be applied in assurance engagements dealing with subject matters other than audits or reviews of historical financial information.

7. International Standards on Related Services (ISRSs) are to be applied to compilation engagements, engagements to apply agreed upon procedures to information and other related services engagements as specified by the IAASB.

8. ISAs, ISREs, ISAEs and ISRSs are collectively referred to as the IAASB’s Engagement Standards.

9. International Standards on Quality Control (ISQCs) are to be applied for all services falling under the IAASB’s Engagement Standards.

International Standards on Auditing

10. ISAs are written in the context of an audit of financial statements by an independent auditor. They are to be adapted as necessary in the circumstances when applied to audits of other historical financial information. The authority of ISAs is set out in ISA 200 (Revised and Redrafted), “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing.”

11. 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. It is undertaken to enhance the degree of

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31 The terms and concepts in this Preface are explained further in the ISAs, in particular in ISA 200, “Objective and General Principles Governing an Audit of Financial Statements.” (ISA 200 will be revised, inter alia, to incorporate relevant provisions of this Preface that deal with the obligations of the auditor, and the status and authority of objectives, requirements and other material. When ISA 200 is revised and exposed for public comment in 2007, respondents will be invited to comment on the material derived from this Preface in that new context.)

32 Unless otherwise stated, “financial statements” mean financial statements comprising historical financial information.

33 Referred to hereafter as “the auditor.”
confidence of intended users in the financial statements. ISAs, taken together, provide the
standards for the auditor’s work in fulfilling this objective.

12. In conducting an audit, the overall objective of the auditor is to obtain reasonable assurance
about whether the financial statements as a whole are free from material misstatement,
whether due to fraud or error, and to report on the financial statements in accordance with the
auditor’s findings. In all cases when this overall objective has not been or cannot be
achieved, the ISAs require that the auditor modifies the auditor’s opinion accordingly or
withdraws from the engagement.

13. The auditor applies each ISA relevant to the audit. An ISA is relevant when the ISA is in
effect and the circumstances addressed by the ISA exist.

14. The ISAs deal with the general responsibilities of the auditor, as well as the auditor’s further
considerations relevant to the application of those responsibilities to specific topics. An ISA
contains objectives and requirements together with related guidance in the form of
application and other explanatory material. It may also contain introductory material that
provides context essential to a proper understanding of the ISAs, and definitions. It is,
therefore, necessary to consider the entire text of an ISA to understand and apply its
requirements.

ISA Objectives

15. Each ISA contains an objective or objectives, which provide the context in which the
requirements of the ISA are set. The auditor aims to achieve these objectives, having regard
to the interrelationships amongst the ISAs. For this purpose, the auditor uses the objectives to
judge whether, having complied with the requirements of the ISAs, sufficient appropriate
audit evidence has been obtained in the context of the overall objective of the auditor. Where
an individual objective has not been or cannot be achieved, the auditor considers whether this
prevents the auditor from achieving the auditor’s overall objective.

Requirements

16. The requirements of each ISA are contained in a separate section and expressed using the
word “shall.” The auditor applies the requirements in the context of the other material
included in the ISA.

17. The auditor complies with the requirements of an ISA in all cases where they are relevant in
the circumstances of the audit. In exceptional circumstances, however, the auditor may judge
it necessary to depart from a relevant requirement by performing alternative audit procedures
to achieve the aim of that requirement. The need for the auditor to depart from a relevant
requirement is expected to arise only where the requirement is for a specific procedure to be
performed and, in the specific circumstances of the audit, that procedure would be
ineffective.

18. A requirement is not relevant only in the cases where: the ISA is not relevant; or the
circumstances envisioned do not apply because the requirement is conditional and the
condition does not exist. The auditor is not required to comply with a requirement that is not
relevant in the circumstances of the audit; this does not constitute a departure from the
requirement.
Application and Other Explanatory Material

19. The application and other explanatory material contained in an ISA is an integral part of the ISA as it provides further explanation of, and guidance for carrying out, the requirements of an ISA, along with background information on the matters addressed in the ISA. It may include examples of procedures, some of which the auditor may judge to be appropriate in the circumstances. Such guidance is, however, not intended to impose a requirement.

20. Appendices, which form part of the application and other explanatory material, are an integral part of an ISA. The purpose and intended use of an appendix are explained in the body of the related ISA or within the title and introduction of the appendix itself.

Introductory Material and Definitions

21. Introductory material may include, as needed, such matters as explanation of: the purpose and scope of the ISA, including how the ISA relates to other ISAs; the subject matter of the ISA; specific expectations on the auditor and others; and the context in which the ISA is set.

22. An ISA may include, in a separate section under the heading ‘Definitions’, a description of the meanings attributed to certain terms for purposes of the ISAs. These are provided to assist in the consistent application and interpretation of the ISAs, and are not intended to override definitions that may be established for other purposes, whether in law, regulation or otherwise. Unless otherwise indicated, those terms will carry the same meanings throughout the ISAs. The Glossary of Terms in the Handbook contains a complete listing of terms defined in the ISAs. It also includes descriptions of other terms found in ISAs to assist in common and consistent interpretation and translation.

International Standards on Quality Control

123. ISQCs are written to apply to firms in respect of all their services falling under the IAASB’s Engagement Standards. The authority of ISQCs is set out in the introduction to the ISQCs.

Other International Standards

[There are no changes proposed to paragraphs 24-33, except renumbering. According, they are not reproduced.]
Proposed Conforming Amendments to Final Clarified ISAs

ISA 230 (Redrafted), “Audit Documentation”

Nature and Purposes of Audit Documentation

2. Audit documentation that meets the requirements of this ISA and the specific documentation requirements of other relevant ISAs provides:
   (a) Evidence of the auditor’s basis for a conclusion about the achievement of the overall objectives of the auditor; and
   (b) Evidence that the audit was planned and performed in accordance with ISAs and applicable legal and regulatory requirements.

Documentation of Significant Matters and Related Significant Professional Judgments (Ref: Para. 8(c))

A11. The auditor may consider it helpful to prepare and retain as part of the audit documentation a summary (sometimes known as a completion memorandum) that describes the significant matters identified during the audit and how they were addressed, or that includes cross-references to other relevant supporting audit documentation that provides such information. Such a summary may facilitate effective and efficient reviews and inspections of the audit documentation, particularly for large and complex audits. Further, the preparation of such a summary may assist the auditor’s consideration of the significant matters. It may also help the auditor to consider whether, in light of the audit procedures performed and conclusions reached, there is any individual relevant ISA objective that the auditor cannot achieve to the satisfaction of the auditor has not met or is unable to meet that would prevent the auditor from achieving the overall objectives of the auditor’s overall objective.

Departure from a Relevant Requirement (Ref: Para. 12)

A18. The objectives and requirements of the ISAs are designed to enable the auditor to achieve the objectives specified in the ISAs, and thereby support the achievement of the overall objectives of the auditor. Accordingly, other than in exceptional circumstances, the ISAs call for compliance with each requirement that is relevant in the circumstances of the audit.

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A19. The documentation requirement applies only to requirements that are relevant in the circumstances. A requirement is not relevant only in the cases where:

(a) The entire ISA is not relevant (for example, if an entity does not have an internal audit function in a continuing engagement, nothing in [proposed] ISA 6510 (Redrafted) is relevant); or

(b) The circumstances envisioned do not apply because the requirement is conditional and the condition does not exist (for example, the requirement to modify the auditor’s opinion where there is an inability to obtain sufficient appropriate audit evidence, and there is no such inability).

ISA 240 (Revised and Redrafted), “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”

Responsibilities of the Auditor

5. An auditor conducting an audit in accordance with ISAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, 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 the ISAs.

6. As described in ISA 200 (Revised and Redrafted), the potential effects of inherent limitations are particularly significant in the case of misstatement resulting from fraud. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is 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.

7. 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, present fraudulent financial

36 [Proposed] ISA 200 (Revised and Redrafted), paragraph 22[27].
39 ISA 200 (Revised and Redrafted), paragraph A50.
information or override control procedures designed to prevent similar frauds by other employees.

8. When obtaining reasonable assurance, the auditor is responsible for maintaining an attitude of professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud. The requirements in this ISA are designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.

... Professional Skepticism

12. In accordance with ISA 200 (Revised and Redrafted)\textsuperscript{40}, the auditor shall maintain an attitude of professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor’s past experience of the honesty and integrity of the entity’s management and those charged with governance.\textsuperscript{41}

... A7. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. Maintaining an attitude of professional skepticism requires an ongoing questioning of whether the information and audit evidence obtained suggests that a material misstatement due to fraud may exist. It includes considering the reliability of the information to be used as audit evidence and the controls over its preparation and maintenance where relevant. Due to the characteristics of fraud, the auditor’s attitude of professional skepticism is particularly important when considering the risks of material misstatement due to fraud.

A8. Although the auditor cannot be expected to disregard past experience of the honesty and integrity of the entity’s management and those charged with governance, the auditor’s attitude of professional skepticism is particularly important in considering the risks of material misstatement due to fraud because there may have been changes in circumstances.

A9. An audit performed in accordance with ISAs rarely involves the authentication of documents, nor is the auditor trained as or expected to be an expert in such authentication. However, when the auditor identifies conditions that cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, possible procedures to investigate further may include:

- Confirming directly with the third party.
- Using the work of an expert to assess the document’s authenticity.

\textsuperscript{40} ISA 200 (Revised and Redrafted), paragraph 15.
\textsuperscript{41} [Proposed] ISA 200 (Revised and Redrafted), paragraph [18].
ISA 260 (Revised and Redrafted), “Communication with Those Charged with Governance”

Definitions

6. For purposes of the ISAs, the following terms have the meanings attributed below:

(a) Those charged with governance – The person(s) or organization(s) (e.g., a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities in some jurisdictions, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager. In some cases, those charged with governance are responsible for approving the entity’s financial statements (in other cases management has this responsibility). For discussion of the diversity of governance structures, see paragraphs A5-A12.

(b) Management – The person(s) with executive responsibility for the conduct of the entity’s operations. For some entities in some jurisdictions, management includes some or all of those charged with governance, for example, executive members of a governance board, or an owner-manager. Management is responsible for the preparation of the financial statements, overseen by those charged with governance, and in some cases management is also responsible for approving the entity’s financial statements (in other cases those charged with governance have this responsibility).

Those Charged with Governance (Ref: Para. 7)

A5. Governance structures vary by jurisdiction and by entity, reflecting influences such as different cultural and legal backgrounds, and size and ownership characteristics. For example:

- In some jurisdictions a supervisory (wholly or mainly non-executive) board exists that is legally separate from an executive (management) board (a “two-tier board” structure). In other jurisdictions, both the supervisory and executive functions are the legal responsibility of a single, or unitary, board (a “one-tier board” structure).

- In some entities, those charged with governance hold positions that are an integral part of the entity’s legal structure, for example, company directors. In others, for example, some government entities, a body that is not part of the entity is charged with governance.

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42 As described at paragraph [A43] of [proposed] ISA 700, (Redrafted), “The Independent Auditor’s Report on General Purpose Financial Statements,” having responsibility for approving in this context means having the authority to conclude that all the statements that comprise the financial statements, including the related notes, have been prepared.

43 See footnote 1.
In some cases, some or all of those charged with governance are involved in managing the entity. In others, those charged with governance and management comprise different persons.

In some cases, those charged with governance are responsible for approving the entity’s financial statements (in other cases management has this responsibility).

A6. In most entities, governance is the collective responsibility of a governing body, such as a board of directors, a supervisory board, partners, proprietors, a committee of management, a council of governors, trustees, or equivalent persons. In some smaller entities, however, one person may be charged with governance, for example, the owner-manager where there are no other owners, or a sole trustee. When governance is a collective responsibility, a subgroup such as an audit committee or even an individual, may be charged with specific tasks to assist the governing body in meeting its responsibilities. Alternatively, a subgroup or individual may have specific, legally identified responsibilities that differ from those of the governing body.

**All Final Clarified ISAs**

*Phrases*

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“attitude of professional skepticism”
- ISA 250 (Redrafted), paragraph 8.
- ISA 540 (Revised and Redrafted), paragraph A40.
- ISA 550 (Revised and Redrafted), paragraph A9.
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“affected by the inherent limitations of inherent to internal control”
- ISA 315 (Redrafted), paragraph A42.
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44 As described at paragraph [A43] of [proposed] ISA 700, (Redrafted), “The Independent Auditor’s Report on General Purpose Financial Statements,” having responsibility for approving in this context means having the authority to conclude that all the statements that comprise the financial statements, including the related notes, have been prepared.