



Committee: IAASB Consultative Advisory Group

Meeting Location: New York

Meeting Date: April 2-3, 2007

IAASB Clarity Project – Proposed ISA 200 (Revised and Redrafted)

Objectives of Agenda Item

1. In September 2006, the IAASB approved amendments to the *Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services* (Preface). These amendments contain important statements about the authority of the IAASB's Standards, and the obligations of professional accountants who follow those Standards.
2. Because the Preface may not be reproduced or adopted in certain jurisdictions, the IAASB has agreed that relevant provisions of it should be incorporated in ISA 200, "Objective and General Principles Governing an Audit of Financial Statements" when it is revised and redrafted in accordance with IAASB's Clarity conventions.
3. At the September 11-12, 2006 IAASB CAG meeting, Representatives discussed a preliminary draft of proposed ISA 200 (Revised and Redrafted), "Overall Objective of the Independent Auditor, and Concepts Relevant to an Audit of Financial Statements" that included relevant provisions of the proposed amended Preface. Proposed ISA 200 is scheduled for approval as an exposure draft at the April 2007 IAASB meeting. When it is exposed, respondents will be able to comment on the material contained in the amended Preface in that new context.
4. The objectives of this Agenda Item are:
 - To provide a brief report back on the September 11-12, 2006 proposals of Representatives on the preliminary draft of proposed ISA 200 (Revised and Redrafted).
 - To obtain the views of Representatives on key issues to be considered by the IAASB at its April 2007 meeting.

September 11-12, 2006 CAG Proposals

5. Below are extracts from the minutes of the September 11-12, 2006 CAG meeting¹ related to the preliminary draft of proposed ISA 200, and an indication of how the IAASB Task Force or the IAASB responded to the Representatives' comments.

¹ The minutes will be approved at the April 2007 IAASB CAG meeting.

IAASB CAG PAPER

IAASB CAG Agenda (April 2007)

Agenda Item E.1

Clarity – Proposed ISA 200 (Revised and Redrafted) – Cover Memorandum

Representatives' comments	IAASB Task Force/IAASB response
Mr. Diomeda noted that the proposed amended ISA 230, "Audit Documentation" explains that the documentation requirement applies only to requirements that are relevant in the circumstances, while the proposed amended ISA 200 provides guidance for determining whether a requirement is relevant in the circumstances. He asked how the auditor should interpret the connection between the material in ISA 230 and the guidance in ISA 200...	The ISAs are to be read together, and the authoritative guidance in ISA 200 provides an appropriate explanation of the meaning of the phrase 'relevant requirements' wherever it may appear in the ISAs. However, to ensure clarity and no possible misunderstanding, the guidance in proposed ISA 230 (Redrafted), "Audit Documentation" and proposed ISA 200 have been made consistent, and aspects of the guidance repeated in both ISAs. Refer to paragraphs A16-A17 of ED ISA 230 (Redrafted)², and paragraph A68 of Agenda Item E.1.1.
... Mr. Damant noted...that the objective of an audit ...had been removed from paragraph 2 of the old ISA, where it was suitably prominent, and was somewhat lost in paragraph 6. He questioned the logic of the proposed wording.	The Task Force and IAASB agree with this observation and, accordingly, the objective of an audit (together with related explanatory material) has been repositioned in proposed ISA 200 to give it greater prominence. Refer to paragraphs 4-7 of Agenda Item E.1.1
Mr. Hegarty was of the view that ISA 200 could be used to set the audit in the context of the financial reporting supply chain and to explain the dependence of audit quality on other factors such as the financial reporting framework. He was of the view that the ISAs should be framework neutral but should recognize that legislators or regulators might therefore require an audit scope that is wider than that provided for in the ISAs.	The Task Force does not believe that the clarity or understandability of ISA 200 would be enhanced by the inclusion of an explanation of an audit in the context of the financial reporting supply chain. However, it agrees that the level of assurance that an audit can provide is dependent, to some extent, on external factors such as the financial reporting framework. The Task Force has therefore expanded the discussion of such factors as part of the discussion in proposed ISA 200 of the sources of the inherent limitations of an audit. Refer to discussion in paragraphs 26-27 of Section II of this Paper, and paragraphs A33-A45 of Agenda Item E.1.1
Mr. Rabine emphasized the importance of ISA 200. He noted that the EGAOB has not yet reviewed the proposed amendments to ISA 200; however, he was of the view that paragraphs A8 (authentication of	The IAASB is satisfied that ISA 240 (Redrafted), "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" ³ appropriately directs the auditor to investigate further if conditions

² Available from <http://www.ifac.org/Guidance/EXD-Details.php?EDID=0071>

³ Available from <http://www.ifac.org/Members/DownLoads/IAASB-RD-ISAS-RedraftedISAs.pdf>

IAASB CAG PAPER

IAASB CAG Agenda (April 2007)

Agenda Item E.1

Clarity – Proposed ISA 200 (Revised and Redrafted) – Cover Memorandum

Representatives' comments	IAASB Task Force/IAASB response
documents) and A11 (professional judgment) might be problematic.	<p>identified during the audit 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. Further, the Task Force has repositioned in proposed ISA 200 the discussion of authentication of documents as part of its explanation of the concept of professional skepticism, for emphasis. Refer to paragraph A32 of Agenda Item E.1.1</p> <p>With respect to professional judgment, the Task Force and IAASB accept that there may be concern by some about the potential for professional judgment to be used as a fall-back basis for decisions when questions are raised about how conclusions have been drawn. The Task Force and IAASB have therefore expanded the discussion of professional judgment in proposed ISA 200 to explain when the exercise of professional judgment would be regarded as reasonable. Refer to paragraph A30 of Agenda Item E.1.1</p>

Significant Issues to be Considered by the IAASB in April

I. Obligation Attaching to Objectives

6. The October 2005 Exposure Draft of the amended Preface stated the following with respect to objectives:

“The [auditor] must achieve the objective stated at the beginning of each Standard that is relevant in the circumstances of the engagement. The [auditor] achieves the objective by complying with the requirements of the Standard, and by performing other procedures that, in the [auditor’s] professional judgment, are necessary in the circumstances.”

7. The principal concern noted with that proposed obligation was that it is too absolute. In response to this and other valid points made in response to the October 2005 Exposure Draft, the IAASB amended the Preface, changing the “must achieve” obligation to “shall aim to achieve...having regard to the interrelationships amongst the ISAs”, and specifying the consequence of a failure to achieve an objective. Accordingly, paragraph 15 of the amended Preface approved in September states the following:

“...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

IAASB CAG PAPER

IAASB CAG Agenda (April 2007)

Agenda Item E.1

Clarity – Proposed ISA 200 (Revised and Redrafted) – Cover Memorandum

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.”

8. During IAASB discussion of the preliminary draft of ISA 200, it was suggested that the order in which the elements of paragraph 15 of the amended Preface were presented did not provide the best support for the obligation in respect of objectives. It was suggested, for example, that the consequences of a failure to achieve an objective should be set out immediately after the obligation. Further, it was suggested that reproducing the relevant provisions of the Preface in ISA 200 gave the IAASB the opportunity to provide more explanation to enhance the understanding of the requirements derived from the Preface in this new context.
9. As a result, the proposed ISA 200 submitted to the IAASB for discussion and approval at its April meeting reflects consideration of the following:
 - A. *The most appropriate approach to the presentation in ISA 200 of the material derived from the amended Preface relating to objectives, including where appropriate the need to reposition elements of that material; and*
 - B. *The nature and extent of the essential explanatory material and application and other explanatory material needed in the draft.*
10. These matters are described below, reflecting the proposals of the IAASB Task Force responsible for revising ISA 200.

A. REPOSITIONING OF MATERIAL

11. Certain elements of the obligation in paragraph 15 of the amended Preface (see paragraph 7 above) have been repositioned in proposed ISA 200 to make clear that the obligation on the auditor to ‘aim to achieve’ the objectives is a robust one, and to clarify the intended use of the objectives by the auditor.
12. Specifically, proposed ISA 200:
 - Presents the required consideration of the consequence of failure to achieve an objective immediately after the ‘aim to achieve’ obligation (that is, it presents together the first and third sentences of the obligation stated in the amended Preface noted in paragraph 7 above) **Refer to paragraph 16 of Agenda Item E.1.1**; and
 - Includes the overarching bold type requirement of extant ISA 500, “Audit Evidence”, for the auditor to obtain sufficient appropriate audit evidence. This is a fundamental audit requirement, appropriate for inclusion in ISA 200, and provides appropriate context for the requirement that the auditor use objectives to consider whether sufficient appropriate audit evidence has been obtained (that is, the second sentence of the obligation noted in paragraph 15 of the amended Preface (see paragraph 7 above)). The context is further improved by placing this after setting out the obligation to comply with the requirements of ISAs. **Refer to paragraphs 19 and 20 of Agenda Item E.1.1**

IAASB CAG PAPER

IAASB CAG Agenda (April 2007)

Agenda Item E.1

Clarity – Proposed ISA 200 (Revised and Redrafted) – Cover Memorandum

13. The above changes have the following benefits. First, they make clear that either the objectives have to be met, or where they cannot be met, some consequential action has to be taken. This reinforces the strength of the obligation attaching to the objectives.
14. Second, they deal with a possible problem in the logical flow of the wording in the Preface obligation, which appears to address first the achievement of *individual* objectives, then moves to the consideration of the sufficiency and appropriateness of audit evidence in light of the *objectives and requirements of all of the ISAs*, and then reverts to dealing with the consequence of failure to achieve an *individual objective*.
15. Third, they present the auditor's use of the objectives in relation to the obtaining of sufficient appropriate audit evidence in its logical position, as it is a matter considered once the auditor has complied with relevant requirements of the ISAs. Further, the proposed repositioning avoids the risk of incorrect inferences being drawn that the only purpose for which the objectives are used is in relation to judging whether sufficient appropriate audit evidence has been obtained, and that the objectives are only effective in the case of ISAs that deal with obtaining such evidence.
16. Finally, the introduction of the ISA 500 requirement to obtain sufficient appropriate audit evidence provides the appropriate context for, and more importantly reinforces, the use of the objectives.

B. FURTHER ESSENTIAL EXPLANATORY MATERIAL AND APPLICATION AND OTHER EXPLANATORY MATERIAL

17. Proposed ISA 200 contains further explanation of the following:

- The meaning and robustness of the 'aim to achieve' obligation;
- The auditor's consideration of objectives;
- The consequence of a failure to achieve an objective;
- The consequence of a failure to obtain sufficient appropriate audit evidence; and
- The relationship between objectives and requirements.

Further Explanation of the Meaning and Robustness of the 'Aim to Achieve' Obligation

18. Proposed ISA 200 explains further the basis for, and the force of, the phrase 'aim to' in the obligation for objectives. Specifically, the application material of proposed ISA 200 makes clear, and explains further, that the achievement of an objective:
 - Is not always possible;
 - Is subject to inherent limitations of an audit; and
 - Is to be understood in the context of the concepts relevant to an audit of financial statements.

IAASB CAG PAPER

IAASB CAG Agenda (April 2007)

Agenda Item E.1

Clarity – Proposed ISA 200 (Revised and Redrafted) – Cover Memorandum

However, the application material also highlights the fact that the obligation is in fact robust, drawing attention in particular to the other requirements of proposed ISA 200 that reinforce the requirement to aim to achieve the objectives. **Refer to paragraph A62 of Agenda Item E.1.1**

Further Explanation of the Auditor's Consideration of Objectives

19. An important element of the obligation to aim to achieve the objectives is the acknowledgment that the ISAs taken together support the achievement of the auditor's overall objectives and, therefore, that the auditor needs to consider the objectives having regard to the interrelationships amongst the ISAs. Accordingly, proposed ISA 200 explains further the auditor's consideration of the interrelationships among the ISAs. **Refer to paragraph A63 of Agenda Item E.1.1**

Further Explanation of the Consequence of a Failure to Achieve an Objective

20. The amended Preface states "...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." It is proposed, however, that ISA 200 states that in most cases a failure to achieve an objective will in fact prevent the achievement of overall objective (i.e., the auditor will have been unable to achieve reasonable assurance or unable to report in accordance with the auditor's findings). **Refer to last sentence of paragraph 16 of Agenda Item E.1.1.**
21. In support of this statement, the IAASB Task Force reviewed the list of draft ISA objectives **(see Agenda Item E.1.2)**⁴. Of the 32 ISAs, it could identify only those objectives relating to ISAs 210, 220, 230 and 260 as possibly containing objectives that appear to relate only indirectly to obtaining reasonable assurance or reporting in accordance with auditor's findings, and which one might possibly view as being able to be 'breached' without preventing the achievement of the auditor's overall objective. However, even in those cases there would be substantial risk that this would not be the case, and there are arguments to suggest that the auditor would in fact find it difficult to demonstrate that reasonable assurance has been obtained if those were in fact not achieved⁵.
22. Accordingly, proposed ISA 200 introduces application material that explains further this point. ISAs 220 and 230 have been used as examples for this purpose. **Refer to paragraphs A64-A66 of Agenda Item E.1.1**

⁴ The Representatives are asked to note that the Task Force is contemplating that an updated list of draft ISA objectives shown in Agenda Item E.1.2 be made available as a supplement (with appropriate caveats) to the proposed ISA 200 exposure draft in order to assist respondents in considering that document.

⁵ For example, ISA 210 (Terms of Engagements) relates indirectly to the performance of the audit, as it deals with engagement acceptance. However, a failure to avoid the acceptance an inappropriate engagement would necessarily result in a reporting consequence or withdrawal if the audit is conducted properly. Similarly, though a failure to achieve the objectives of ISA 220 (Quality Control) may not have a direct reporting consequence per se, it is inconceivable how the auditor might be satisfied that reasonable assurance has been obtained without assurance through some quality control effort.

IAASB CAG PAPER

IAASB CAG Agenda (April 2007)

Agenda Item E.1

Clarity – Proposed ISA 200 (Revised and Redrafted) – Cover Memorandum

Further Explanation of the Consequence of a Failure to Obtain Sufficient Appropriate Audit Evidence

23. The amended Preface does not address what action may be appropriate in the circumstances where the auditor, having complied with the ISA requirements and considered the ISA objectives, believes that sufficient appropriate audit evidence has not been obtained. Accordingly, proposed ISA 200 introduces additional application guidance to assist the auditor in this regard. **Refer to paragraph A70 of Agenda Item E.1.1**

Further Explanation of the Relationship between Objectives and Requirements

24. It is important that the relationship between objectives and requirements be clear. Accordingly, proposed ISA 200 introduces additional essential explanatory material within the requirements section explaining:
- The purpose and role of the requirements of the ISAs, including the fact that their proper application will generally permit the auditor to achieve the objectives; and **Refer to paragraph 17 in Agenda Item E.1.1**
 - That the requirements cannot anticipate all circumstances and consequently, the auditor may judge it necessary to perform further procedures in pursuance of the objectives. **Refer to the last sentence of paragraph 18 of Agenda Item E.1.1**

Matters for Consideration by the IAASB CAG:

The Representatives are asked for their views on the aspects of proposed revised ISA 200 relating to the obligation to achieve objectives. In particular:

- Does the presentation of the material in paragraphs 15-16 and 19-20 reflect appropriately the related provisions of the amended Preface?
- Is the material proposed as essential explanatory material in paragraphs 16-18, and as application and other explanatory material in paragraphs A61-A66 and A70, sufficient to provide an adequate understanding of the meaning and effect of the obligation attaching to objectives?

II. Concepts Relevant to an Audit of Financial Statements

25. The IAASB has sought to amplify as appropriate the discussion in ISA 200 of the concepts relevant to an audit of financial statements, such as auditor independence, the sufficiency and appropriateness of audit evidence, professional judgment and skepticism, the inherent limitations of an audit, and reasonable assurance⁶. These concepts provide the basis for the

⁶ The IAASB has concluded that the definition of reasonable assurance should remain consistent with that included in the Glossary of Terms in the IFAC Handbook of International Auditing, Assurance, and Ethics Pronouncements, being ‘...a high, but not absolute, level of assurance...’. After careful deliberation, the IAASB has agreed that any significant amendment to the discussion of reasonable assurance in ISA 200 would

IAASB CAG PAPER

IAASB CAG Agenda (April 2007)

Agenda Item E.1

Clarity – Proposed ISA 200 (Revised and Redrafted) – Cover Memorandum

proper understanding of the overall objective of the auditor and the objectives and requirements of the ISAs, and are discussed in proposed ISA 200. **Refer to paragraphs 8 and A3-A47 of Agenda Item E.1.1**

Inherent Limitations

26. Particular interest has been expressed on the subject of how proposed ISA 200 should present and discuss the inherent limitations of an audit. The IAASB is of the view that it would be neither appropriate nor practicable to provide a complete list of inherent limitations. Rather, it has been suggested that proposed ISA 200 should approach this matter by focusing on the source and nature of different limitations, and the use of general categories for this purpose.
27. Accordingly, proposed ISA 200 describes the inherent limitations in the context of the following principal sources that give rise to them, thereby making the achievement of absolute assurance impossible:
- The fundamental nature and characteristics of financial reporting and business processes;
 - The need for the audit to be conducted within a reasonable period of time and at a reasonable cost; and
 - The nature of audit evidence and procedures.

These sources, and the principal inherent limitations arising from them, are described in proposed ISA 200. **Refer to paragraphs A33-A45 of Agenda Item E.1.1**

Matters for Consideration by the IAASB CAG:

The Representatives are asked for their views on:

- The concepts listed in paragraph 8 of proposed ISA 200 and the related discussions thereof in paragraphs A3-A45, and whether they appear sufficient to provide a proper understanding of the overall objective of the auditor and the objectives and requirements of the ISAs.
- The proposed categories of sources of inherent limitations of an audit, and the discussion of the principal inherent limitations arising from them, as set out in paragraphs A33-A45 of proposed ISA 200.

necessarily involve a re-examination of the concept, with it being noted that it was previously agreed that work on a conceptual framework (and by implication on such concepts as reasonable assurance) should not form part of the Clarity project. Further, any further consideration would have to be undertaken in consultation with national standard setters, regulators and other stakeholders through a systematic and broader-based study. This is beyond the scope of the work to clarify ISA 200.

IAASB CAG PAPER

IAASB CAG Agenda (April 2007)

Agenda Item E.1

Clarity – Proposed ISA 200 (Revised and Redrafted) – Cover Memorandum

III. Other Matters for Consideration

Matters for Consideration by the IAASB CAG:
The Representatives are asked for their views on any other aspect of proposed ISA 200 for which further consideration may be needed by the IAASB.

Material Presented

Agenda Item E.1.1	Proposed ISA 200 (Revised and Redrafted)
Agenda Item E.1.2	Draft ISA Objectives (Updated March 1, 2007) (April 2007 IAASB Agenda Item 4-B)
Agenda Item E.1.3	Mapping Document – Source of Material in Proposed Revised ISA 200, and Edits Thereto (April 2007 IAASB Agenda Item 4-C)
Agenda Item E.1.4	Mapping Document – Amended Preface and Extant ISA 200 (April 2007 IAASB Agenda Item 4-D)

In view of the importance of the subject, all the documents for Agenda Item E.1 are CAG Papers.