

The Auditor's Report on Financial Statements

Proposed Revisions to ISA 200

Mark-up showing combined proposed changes to ISA 200 arising from the Reporting Project and from the Audit Risk Exposure Draft

[Note: The proposed changes shown in the mark-up below illustrate both the changes to ISA 200 proposed by the Reporting Task Force and those proposed in the Audit Risk Exposure Draft. The Audit Risk Task Force has not yet concluded whether changes are necessary to the section on Audit Risk and Materiality as a result of the Exposure Draft comments and, therefore, the wording below is that which was in the October 2002 Exposure Draft.]

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

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the objective and general principles governing an audit of financial statements. ~~This ISA is to be read in conjunction with ISA 120 "Framework of International Standards on Auditing."~~

Objective of an Audit

2. **The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified applicable financial reporting framework.** The phrases used to express the auditor's opinion are "give a true and fair view" or "present fairly, in all material respects," which are equivalent terms.
3. Although the auditor's opinion enhances the credibility of the financial statements, the user cannot assume that the opinion is an assurance as to the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity.

General Principles of an Audit

4. **The auditor should comply with the relevant ethical requirements relating to audit engagements, which ordinarily comprise Parts A and B of the *Code of Ethics for Professional Accountants* issued by the International Federation of Accountants together with applicable national requirements where these are more restrictive.**
Ethical principles governing the auditor's professional responsibilities are:
 - (a) Independence;
 - (b) Integrity;
 - (c) Objectivity;
 - (d) Professional competence and due care;
 - (e) Confidentiality;

- (f) Professional behavior; and
- (g) Technical standards.

In addition, under International Standard on Quality Control 1 (ISQC 1), a firm of professional accountants has an obligation to establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and applicable regulatory and legal requirements and that the auditor's reports issued by the firm or engagement partners are appropriate in the circumstances. [Source: ISQC 1 Exposure Draft ¶14-15, ISA 220 Exposure Draft ¶3]

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

Scope of an Audit [Source for this section: adapted from the proposed revised Preface]

7. The term “scope of an audit” refers to the audit procedures deemed necessary in the circumstances to achieve the objective of the audit.
- 7a. **The procedures required to conduct an audit in accordance with ISAs should be determined by the auditor having regard to the requirements of the ISAs and considering any International Auditing Practice Statements that are applicable to the audit engagement. The auditor should also have regard to the requirements of relevant professional bodies, legislation, regulations and, where appropriate, the terms of the audit engagement and reporting requirements.**

¹ Paragraph 6 reflects the changes indicated in ISA 240, “The Auditor’s Responsibility to Consider Fraud and Error in an Audit of Financial Statements” and is effective for audits of financial statements for periods ending on or after June 30, 2002. The original Paragraph 6 is indicated below:

The auditor should plan and perform the audit with an attitude of professional skepticism recognizing that circumstances may exist which cause the financial statements to be materially misstated. For example, the auditor would ordinarily expect to find evidence to support management representations and not assume they are necessarily correct.

- 7b. In an audit conducted in accordance with the ISAs, the auditor is expected to comply with the requirements of the ISAs. The nature of those requirements is such that the auditor is expected to exercise professional judgment in applying them. ISAs contain basic principles and essential procedures together with related guidance in the form of explanatory and other material, which may be in the body of the ISAs or in accompanying appendices. The auditor is also expected to be aware of and consider IAPs applicable to the audit engagement.
- 7c. Auditors may have a number of professional and legal requirements, including relevant national standards, with which they must comply in addition to the ISAs. The ISAs cannot override the local laws and regulations that govern an audit of financial statements. In the event those laws and regulations differ from the ISAs, an audit conducted in accordance with the local laws and regulations will not automatically comply with the ISAs. Auditors may, however, be able to design the audit to enable the auditor to comply with both ISAs and local laws and regulations.
- 7d. The auditor should not represent compliance with the ISAs unless the auditor has complied with all of the requirements of the ISAs.**

Reasonable Assurance

8. An audit in accordance with ISAs is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement. Reasonable assurance is a concept relating to the accumulation of the audit evidence necessary for the auditor to conclude that there are no material misstatements in the financial statements taken as a whole. Reasonable assurance relates to the whole audit process.
9. However, there are inherent limitations in an audit that affect the auditor's ability to detect material misstatements. These limitations result from factors such as:
- The use of testing.
 - The inherent limitations of any accounting and internal control system (for example, the possibility of collusion).
 - The fact that most audit evidence is persuasive rather than conclusive.
10. Also, the work undertaken by the auditor to form an opinion is permeated by judgment, in particular regarding:
- (a) The gathering of audit evidence, for example, in deciding the nature, timing and extent of audit procedures; and
 - (b) The drawing of conclusions based on the audit evidence gathered, for example, assessing the reasonableness of the estimates made by management in preparing the financial statements.
11. Further, other limitations may affect the persuasiveness of evidence available to draw conclusions on particular financial statement assertions (for example, transactions between related parties). In these cases certain ISAs identify specified procedures which will, because of the nature of the particular assertions, provide sufficient appropriate audit evidence in the absence of:
- (a) Unusual circumstances which increase the risk of material misstatement beyond that which would ordinarily be expected; or
 - (b) Any indication that a material misstatement has occurred.

Responsibility for the Financial Statements

- ~~12. While the auditor is responsible for forming and expressing an opinion on the financial statements, the responsibility for preparing and presenting the financial statements is that of the management of the entity. The audit of the financial statements does not relieve management of its responsibilities.~~

Audit Risk and Materiality [Source – paragraphs 12 to 23 from Audit Risk Exposure Draft]

12. Entities pursue strategies to achieve their objectives, and depending on the nature of their operations and industry, the regulatory environment in which they operate, and their size and complexity, they face a variety of business risks. Management is responsible for identifying such risks and responding to them. However, not all risks relate to the preparation of the financial statements. The auditor is concerned only with risks that may affect the financial statements.
13. The auditor obtains and evaluates audit evidence to obtain reasonable assurance about whether the financial statements give a true and fair view (or are presented fairly, in all material respects) in accordance with the applicable financial reporting framework. The concept of reasonable assurance acknowledges that there is a risk the audit opinion is inappropriate. The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated is known as “audit risk.”²
14. **The auditor should plan and perform the audit to reduce audit risk to an acceptably low level.** The auditor reduces audit risk to an acceptably low level by designing and performing audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base an audit opinion.
15. Audit risk is a function of the risk of material misstatement of the financial statements (or simply, the “risk of material misstatement”) (i.e., the risk that the financial statements are materially misstated prior to audit) and the risk that the auditor will not detect such misstatement (“detection risk”). The auditor performs audit procedures to assess the risk of material misstatement and seeks to limit or restrict detection risk by performing further audit procedures based on that assessment (see ISA XX, “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement,” and ISA XX, “The Auditor’s Procedures in Response to Assessed Risks”). The audit process involves the exercise of professional judgment in designing the audit approach, through focusing on what can go wrong (i.e., what are the potential misstatements that may arise) at the assertion level (see ISA XX, “Audit Evidence”).
16. The auditor is concerned only with material misstatements, and is not responsible for the detection of misstatements that are not material to the financial statements taken as a whole. Materiality and audit risk are related (see ISA 320, “Audit Materiality”). The auditor

² This definition of audit risk does not include the risk that the auditor might erroneously conclude that the financial statements are materially misstated. In such a situation, the auditor ordinarily reconsiders or extends audit procedures and requests that management perform specific tasks to reevaluate the appropriateness of the financial statements. These steps ordinarily lead the auditor to the correct conclusion. This definition also excludes the risk of an inappropriate reporting decision unrelated to the detection and evaluation of a misstatement in the financial statements, such as an inappropriate decision regarding the form of the auditor’s report because of a limitation of scope of the audit.

considers risk and materiality at two levels: the overall financial statement level and in relation to the individual classes of transactions, account balances and disclosures and the related assertions.

17. The auditor considers the risk of material misstatement at the overall financial statement level, which refers to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature often relate to the entity's control environment, and are not necessarily risks identifiable with specific assertions at the class of transaction, account balance or disclosure level. Rather, this overall risk represents circumstances that increase the risk that there could be material misstatements in any number of different assertions, for example, through management override of internal control. Such risks may be especially relevant to the auditor's consideration of the risk of material misstatement arising from fraud. The auditor's consideration of the risk of material misstatement at the overall financial statement level includes consideration of the knowledge, skill, and ability of personnel assigned significant engagement responsibilities, including whether to involve experts; the appropriate levels of supervision; and whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.
18. The auditor also considers the risk of material misstatement at the individual class of transaction, account balance and disclosure level because such consideration directly assists in determining the nature, timing, and extent of further audit procedures at the assertion level. The auditor seeks to restrict risks at the individual class of transaction, account balance and disclosure level in such a way that enables the auditor, at the completion of the audit, to express an opinion on the financial statements taken as a whole at an acceptably low level of audit risk. Auditors use various approaches to accomplish that objective.³
19. The discussion in the following paragraphs provides an explanation of the components of audit risk. The risk of material misstatement at the assertion level consists of two components as follows:
 - "Inherent risk" is the susceptibility of an assertion to a material misstatement, assuming that there are no related controls. The risk of such misstatement is greater for some assertions and related classes of transactions, account balances and disclosures than for others. For example, complex calculations are more likely to be misstated than simple calculations. Accounts consisting of amounts derived from accounting estimates pose greater risks than do accounts consisting of relatively routine, factual data. External circumstances also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement. In addition to those circumstances that are peculiar to a specific assertion for a class of transactions, account balance or disclosure, factors in the entity and its environment that relate to several or all of the classes, balances or disclosures may influence the inherent risk related to an assertion for a specific class, balance or disclosure. These latter factors include, for example, a lack of sufficient

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The auditor may make use of a model that expresses the general relationship of the components of audit risk in mathematical terms to arrive at an appropriate level of detection risk. Some auditors find such a model to be useful when planning audit procedures to achieve a desired audit risk though the use of such a model does not eliminate the judgment inherent in the audit process.

working capital to continue operations or a declining industry characterized by a large number of business failures.

- “Control risk” is the risk that a material misstatement that could occur in an assertion will not be prevented, or detected and corrected, on a timely basis by the entity’s internal control. That risk is a function of the effectiveness of the design and operation of internal control in achieving the entity’s objectives relevant to preparation of the entity’s financial statements. Some control risk will always exist because of the inherent limitations of internal control.
20. Inherent risk and control risk are the entity’s risks, and they exist independently of the audit of the financial statements. The auditor is required to assess the risk of material misstatement at the assertion level as a basis for further audit procedures, though that assessment is a judgment, rather than a precise measurement of risk. The ISAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the “risk of material misstatement.” Although the ISAs ordinarily describe a combined assessment of the risk of material misstatement, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risk of material misstatement may be made in quantitative terms, such as in percentages, or in non-quantitative terms across a range. 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.
21. “Detection risk” is the risk that the auditor will not detect a material misstatement that exists in an assertion. Detection risk is a function of the effectiveness of an audit procedure and of its application by the auditor. It arises partly from the fact that the auditor usually does not examine all of a class of transactions, account balance or disclosure and partly because of other uncertainties. Such other uncertainties arise because an auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results. These other uncertainties ordinarily can be reduced to a negligible level through adequate planning, proper assignment of audit staff and supervision and review of the audit work performed.
22. 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. Detection risk bears an inverse relationship to the assessment of the risk of material misstatement at the assertion level. The greater the risk of material misstatement the auditor believes exists, the less the detection risk that can be accepted. Conversely, the less risk of material misstatement the auditor believes exist, the greater the detection risk that can be accepted.

Responsibility for the Financial Statements

23. While the auditor is responsible for forming and expressing an opinion on the financial statements, the responsibility for preparing and presenting the financial statements is that of the management of the entity. The audit of the financial statements does not relieve management of its responsibilities.

Applicable Financial Reporting Framework

24. The financial reporting framework used by management to prepare the financial statements will depend on the users of these statements and on how their needs are addressed in a

particular jurisdiction. In some cases, the financial statements will be intended to meet the common information needs of a wide range of users; in others, they will be intended to meet the specific needs of specifically identified users.

25. Many users rely on financial statements made available by an entity as their major source of financial information about that entity because they do not have the power to obtain additional information to meet their specific needs. While all the information needs of users cannot be met by financial statements made available by an entity, there are needs that are common to all users. As investors are providers of risk capital to the enterprise, it is presumed that financial statements that meet their needs will also meet most of the needs of other users in making economic decisions. As a result, financial statements that are useful to a wide range of users in making economic decisions need to be prepared in accordance with a financial reporting framework that provides information about the financial position, financial performance and cash flows of an entity. Such financial statements are referred to as general purpose financial statements. [Source: IAS Framework paragraphs 10, 11]
26. International Financial Reporting Standards or national accounting standards that satisfy the criteria described in paragraphs 29 and 30, are presumed to be appropriate financial reporting frameworks for general purpose financial statements. ISA 700 “The Auditor’s Report on Financial Statements” addresses the auditor’s report on general purpose financial statements.
27. In special purpose audit engagements, financial statements may be prepared using other bases of accounting. In such circumstances, the applicable financial reporting framework will depend on the information needs of the identified users. Such circumstances and statements are addressed in ISA 800 “The Auditor’s Report on Special Purpose Audit Engagements”.

International Financial Reporting Standards

28. Paragraphs 10 to 19 of International Accounting Standard (IAS) 1 (Revised 1997), “Presentation of Financial Statements,”⁴ set out the requirements to be met before an entity’s financial statements can be regarded as having been prepared in accordance with International Financial Reporting Standards (also referred to as International Accounting Standards). In particular, paragraph 11 indicates that “financial statements should not be described as complying with International Accounting Standards unless they comply with all the requirements of each applicable standard and each applicable interpretation of the Standing Interpretations Committee.”⁵

National Accounting Standards

29. National accounting standards refers to financial reporting standards issued or adopted by national organizations authorized, for example, by legislation to establish such standards in their jurisdiction through an established process involving deliberation and consultation, or

⁴ On May 15, 2002, the International Accounting Standards Board issued an exposure draft of improvements to IASs, including an exposure draft of a proposed revised IAS 1. In that exposure draft, the relevant paragraphs are paragraphs 10-17, with paragraph 11 requiring compliance with all applicable standards.

⁵ The Standing Interpretations Committee was renamed the “International Financial Reporting Interpretations Committee” subsequent to the issue of IAS 1 (Revised 1997).

to adopt International Financial Reporting Standards or the financial reporting standards of another authorized national organization. [Source: consistent with AICPA AU 411.05]

30. For jurisdictions that do not have such organizations, national accounting standards can also refer to financial reporting frameworks that are both comprehensive and authoritative. In such circumstance, a financial reporting framework would be considered to be comprehensive when it results in financial statements that are:

- (a) Relevant to the common information needs of a wide range of users in making economic decisions in that they are designed to present fairly the financial position, financial performance and cash flows of an entity;
- (b) Reliable in that they:
 - (i) represent faithfully the results and financial position of the entity;
 - (ii) reflect the economic substance of events and transactions and not merely the legal form;
 - (iii) are neutral, that is free from bias;
 - (iv) are prudent;
 - (v) are complete in all material respects; and
- (c) Provide sufficient disclosures to enable users to understand the impact of particular transactions or events on the entity's financial positions and financial performance.
[Source for (a) to (c): adapted from IAS 1.15 and .20]

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

Identification of Applicable Financial Reporting Framework for General Purpose Financial Statements

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

32. In addition to specifying the financial reporting framework with which general purpose financial statements are to be prepared, legislation in some jurisdictions sometimes also requires financial statements to comply with certain specified requirements. In these jurisdictions, the applicable financial reporting framework encompasses both the financial reporting framework and the additional requirements specified in legislation.

33. When the entity is registered or operating in a jurisdiction where there are no such legislative and regulatory obligations, the entity identifies an applicable framework. The entity's choice will be governed by local practice, industry practice, user needs, or other factors. For example, the entity's competitors may apply International Financial Reporting Standards and the entity may determine that International Financial Reporting Standards are also appropriate for its financial reporting requirements. [Source for 31 to 33: Adapted from Audit Risk ED- Understanding document, paragraph 30]