

Agenda Item 4-B

Proposed Draft Revised ISA 200 (Clean)

Overall Objective of the Independent Auditor, and Fundamental Concepts Relevant to an Audit of Financial Statements

Introduction

Scope of this ISA

1. This International Standard on Auditing (ISA) establishes the independent auditor's overall responsibilities when conducting an audit in accordance with ISAs.
2. ISAs are written in the context of an audit of financial statements by an independent auditor. They are to be adapted as necessary when applied to audits of other historical financial information.

Effective Date

3. This ISA is effective for audits of financial statements for periods beginning on or after [date].

Overall Objective of the Independent Auditor

4. The objective of an audit of financial statements is to enable the auditor to express an opinion¹ whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.
5. In conducting the audit so as to achieve its objective, the overall objective of the independent auditor² 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.
6. The objective of an audit cannot be fulfilled unless the auditor achieves the overall objective of the auditor. In all cases when the overall objective of the auditor has not been or cannot be achieved, the ISAs require that the auditor modifies the auditor's opinion accordingly or withdraws from the engagement.

¹ The form of opinion will depend upon the applicable financial reporting framework and any applicable law or regulation. Where the applicable financial reporting framework is a fair presentation framework, as is generally the case for general purpose financial statements, the opinion is on whether the financial statements give a true and fair view, or are fairly presented in all material respects – see ISA 700 (Revised), “The Independent Auditor’s Report on General Purpose Financial Statements.” Unless specifically stated otherwise, reference in the ISAs to the auditor’s opinion covers both opinions on whether the financial statements give a true and fair view, or are fairly presented in all material respects, and opinions on compliance with the specific requirements of the applicable financial reporting framework.

² Referred to hereafter and in the ISAs as “the auditor.”

The Objective of an Audit and its Relationship to the Overall Objective of the Auditor

7. An audit of financial statements is an assurance engagement. The financial statements are prepared by the management of the entity, with oversight from those charged with governance. The auditor is engaged for purposes of expressing an opinion designed to enhance the degree of confidence of intended users in the financial statements about whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. The objective of an audit, therefore, is to enable the auditor to express that opinion.
8. The overall objective of the auditor restates the objective of an audit in a way that can more readily be related to the objectives and requirements of the ISAs. For the financial statements to be prepared, in all material respects, in accordance with an applicable financial reporting framework, they must be free from material misstatement. The overall objective of the auditor reflects the fact that the basis for the auditor's opinion is reasonable assurance. This is the level of assurance required by the ISAs, which are designed to support the auditor in obtaining it. The auditor obtains reasonable assurance by accumulating and evaluating sufficient appropriate audit evidence. The auditor's opinion on the financial statements is expressed in a written report.

Fundamental Concepts Relevant to an Audit of Financial Statements

9. Fundamental concepts relevant to an audit of financial statements provide the basis for a proper understanding of the overall objective of the auditor, and the basis on which the ISAs are set. These concepts include the following:
 - Independence and ethical behavior. (Ref: Para. A1-A3)
 - Responsibility for the financial statements. (Ref: Para. A4-A13)
 - Reasonable assurance and the inherent limitations of an audit. (Ref: Para. A14-A24)
 - Professional judgment. (Ref: Para. A25-A26)
 - Professional skepticism. (Ref: Para. A27-A28)
 - Sufficiency and appropriateness of audit evidence. (Ref: Para. A29-A32)
 - Materiality and audit risk. (Ref: Para. A33-A42)

Definitions

10. For purposes of the ISAs, the following terms have the meanings attributed below:
 - (a) Audit evidence – All of the information used by the auditor in arriving at the conclusions on which the audit opinion is based.

- (b) Audit risk – The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.³
- (c) Compliance framework – A financial reporting framework that requires compliance with the specific requirements of the framework, but does not contain the same acknowledgements present in a fair presentation framework (see definition below).
- (d) Detection risk – The risk that the auditor's procedures will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.
- (e) Fair presentation framework – A financial reporting framework that:
 - (i) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond 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.
- (f) Financial statements – A structured representation of historical financial information, which ordinarily includes 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 term ordinarily refers to a complete set of financial statements, but can also refer to a single financial statement⁴.
- (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) 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 and may result from:
 - (i) An inaccuracy in gathering or processing data from which the financial statements are prepared;
 - (ii) An omission of an amount or disclosure;

³ This definition does not include the risk that the auditor might erroneously express an opinion that the financial statements are materially misstated when they are not.

⁴ Examples of a single financial statement are listed in the Appendix of this ISA.

- (iii) An incorrect accounting estimate arising from overlooking or clear misinterpretation of facts; and
- (iv) Management's judgments concerning accounting estimates that the auditor considers unreasonable or the selection and application of accounting policies that the auditor considers inappropriate.

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.

- (i) Reasonable assurance – In the context of an audit of financial statements, a high, but not absolute, level of assurance.
- (j) Risk of material misstatement – The risk that the financial statements are materially misstated. This consists of two components, described as follows at the assertion level:
 - Inherent risk – The susceptibility of an assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there are no related controls.
 - Control risk – The risk that a misstatement that could occur in an assertion and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

Requirements

Ethical Requirements Relating to an Audit of Financial Statements

- 11. The auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to audit engagements. (Ref: Para. A43-A44)

Professional Skepticism

- 12. The auditor shall plan and perform an audit with an attitude of professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated. (Ref: Para. A45)

Conduct of an Audit in Accordance with ISAs

- 13. The ISAs as a whole are set to support the achievement of the auditor's overall objective and accordingly, 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. The auditor shall consider the entire text of an ISA to understand its requirements. (Ref: Para. A46-A51)
- 14. In conducting an audit in accordance with ISAs, the auditor shall aim to achieve the objectives stated in the individual ISAs, having regard to the interrelationships amongst the

ISAs. For this purpose, the auditor shall use the objectives to judge whether, having complied with the requirements of the ISA, 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 shall consider whether this prevents the auditor from achieving the auditor's overall objective. (Ref: Para. A52-A53)

15. In conducting an audit in accordance with ISAs, the auditor shall:

- (a) Apply the requirements (contained in a separate section in each ISA and expressed using the word "shall") in the context of the other material included in the ISA; and
- (b) Comply with the requirements of an ISA in all cases where such requirements are relevant in the circumstances of the audit, unless, in exceptional circumstances, the auditor judges it necessary to depart from a relevant requirement by performing alternative audit procedures to achieve the aim of that requirement. (Ref: Para. A54-A55)

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Application and Other Explanatory Material

Fundamental Concepts Relevant to an Audit of Financial Statements (Ref: Para. 9)

Independence and Ethical Behavior

- A1. The independence of both the firm and the auditor from the entity whose financial statements are subject to audit allows the auditor to form an audit opinion without being affected by influences that might compromise professional judgment. Independence allows the auditor to act with integrity, to be objective and to maintain an attitude of professional skepticism.
- A2. The concept of independence refers both to the state of mind of the auditor and, because of the relevance of an audit of financial statements to a wide range of users in particular, independence in appearance. In applying the concept of independence, the significance of the economic, financial and other relationships is evaluated in light of what a reasonable and informed third party having knowledge of all relevant information would reasonably conclude to be unacceptable in the circumstances.
- A3. The auditor is subject to independence and other ethical requirements relating to an audit of financial statements, which ordinarily comprise Parts A and B of the International Federation of Accountants' Code of Ethics for Professional Accountants (IFAC Code) together with national requirements that are more restrictive.

Responsibility for the Financial Statements

- A4. The concept of an independent audit is premised on the fact that the financial statements subject to audit are those of the entity, prepared and presented by management of the entity

with oversight from those charged with governance,⁵ with the auditor engaged for purposes of forming and expressing an opinion on them. The audit of the financial statements does not relieve management and those charged with governance of their responsibilities. The auditor is also entitled to expect that management and those charged with governance will make available to the auditor all the information the auditor requires for the purposes of the audit.

- A5. Accordingly, ISAs are written, and audits are conducted, on the premises that management and, where appropriate, those charged with governance:
- Acknowledge and understand their responsibility for preparing and presenting the financial statements in accordance with the applicable financial reporting framework (see paragraphs A7-A13);
 - Acknowledge and understand their responsibility for designing, implementing and maintaining internal control relevant to the preparation and presentation of financial statements that are free from material misstatement, whether due to fraud or error; and
 - Will provide complete information to the auditor.
- A6. Since these premises are fundamental to the audit, as part of agreeing the terms of engagement the auditor is required by [proposed] ISA 210, “Terms of Audit Engagements” to obtain confirmation that management and, where appropriate, those charged with governance, acknowledge and understand those responsibilities. As the audit progresses, the auditor obtains audit evidence about these matters. Written representations about these matters constitute an essential part of sufficient appropriate audit evidence. Accordingly, the auditor is required by [proposed] ISA 580, “Written Representations” to obtain such written representations.
- A7. As part of its responsibility for preparing and presenting the financial statements, management is responsible for identifying the financial reporting framework to be adopted (“the applicable financial reporting framework”), in the context of any relevant law or regulation. Management is also responsible for preparing and presenting the financial statements in accordance with that framework, and adequately describing that framework in the financial statements. Management’s responsibility for preparing and presenting the financial statements in accordance with the applicable financial reporting framework includes:
- Designing, implementing and maintaining internal control relevant to preparing and presenting financial statements that are free from material misstatement, whether due to fraud or error; (see paragraph A5);
 - Selecting and applying appropriate accounting policies; and
 - Making accounting estimates that are reasonable in the circumstances.

⁵ The terms “management” and “those charged with governance” are described in ISA 260, “Communications with Those Charged with Governance.”

- A8. 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” prepared in accordance with a “general purpose framework”) or to meet the financial information needs of specific users (i.e., “special purpose financial statements” prepared in accordance with a “special purpose framework”).
- A9. 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.

- A10. 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.
- A11. 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).
- A12. 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.

- A13. ISA 210 contains standards and guidance on determining the acceptability of the applicable financial reporting framework. ISA 800, “Special Considerations—Audits of Special Purpose Financial Statements and Specific Elements, Accounts or Items of a Financial Statement” contains additional considerations for special purpose frameworks.

Reasonable Assurance

- A14. The auditor’s overall objective 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. Reasonable assurance is a concept relating to the accumulation of the audit evidence necessary for the auditor to express an opinion on the financial statements. It requires the exercise of professional judgment throughout the audit in identifying and assessing risks of material misstatement, in performing audit procedures in response to the assessed risks in order to obtain audit evidence to reduce audit risk, and in forming conclusions based on an evaluation of that evidence. Reasonable assurance is obtained when the auditor has reduced audit risk to an acceptably low level by obtaining sufficient appropriate audit evidence.
- A15. Reasonable assurance is a high, but not absolute, level of assurance. An auditor cannot obtain absolute assurance, i.e. certainty. This is primarily because there are inherent limitations of an audit (described below) that affect the auditor’s ability to detect material misstatements, whether due to fraud or error. Because of these limitations, an audit is not a guarantee that the financial statements are free from material misstatement due to fraud or error. Consequently, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with ISAs. Accordingly, the subsequent discovery of a material misstatement of the financial statements resulting from fraud or error does not, in and of itself, indicate a failure to conduct an audit in accordance with ISAs. 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.

Inherent Limitations of an Audit

- A16. There are several factors that give rise to the inherent limitations of an audit. Paragraphs A17-A24 describe the principal factors, while other ISAs may provide further explanation of limitations that are of particular relevance to their subject matter, e.g. ISA 240, “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements.” Inherent

limitations, by their nature, cannot be overcome, but the ISAs provide requirements and guidance to assist the auditor in mitigating their effect.

- A17. The inherent limitations of an audit in part result from an expectation that the auditor will form an opinion on the financial statements within a reasonable period of time and at a reasonable cost. Underlying this expectation is the understanding that the auditor is not expected 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. To do otherwise would neither be cost effective nor allow the audited financial statements to be available in time to be relevant. However, the matter of time or cost involved is not in itself a valid basis for the auditor to be satisfied with audit evidence that is less than persuasive.
- A18. Consequently, the auditor uses testing, including sampling, and other means of examining populations for misstatements. Although samples with high levels of confidence can be designed, there is always risk that the sample is not representative of the population and a material misstatement will fail to be detected. Similarly analytical procedures cannot be designed or performed to a level of precision sufficient to ensure that all material misstatements would be detected.
- A19. Further, to form an opinion on the financial statements within a reasonable period of time and at a reasonable cost, the auditor needs to design an audit approach that focuses audit effort on identifying and assessing risks of material misstatement, and in performing audit procedures in response to the assessed risks. The assessment of risks of material misstatement, however, is a judgment rather than a precise measurement.
- A20. 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. Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, falsified documentation which may cause the auditor to believe that audit evidence is valid when it is not. Because of this, ISA 240 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.
- A21. In addition, the evidence available to the auditor includes information about the entity's internal control. 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. 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 limitations inherent in internal control. These include, for example, the possibility of human errors or mistakes and that controls may be circumvented by collusion or inappropriate management override. Neither the entity nor the auditor can overcome fully such inherent limitations.
- A22. Furthermore, the preparation of financial statements in accordance with the entity's applicable financial reporting framework involves judgment by management in applying the requirements of the financial reporting framework to the facts and circumstances of the

entity. Although some financial statement items may be determined on the basis of objective and verifiable facts, others involve subjective decisions, for example, the estimation of the outcome of uncertain events that may only be confirmed in the future.

- A23. Because of the above, and because of the nature of audit evidence and evidence gathering procedures, it is necessary for the auditor to form an opinion based on audit evidence that is persuasive rather than conclusive. However, while it is not possible to obtain conclusive evidence, it must be sufficient and appropriate to reduce audit risk to an acceptably low level.
- A24. An audit is also necessarily limited by its objective, which is an expression of an opinion on the financial statements. For example, an audit opinion does not assure the future viability of the entity or the efficiency or effectiveness with which management has conducted the affairs of the entity (including the effectiveness of internal control).

Professional Judgment

- A25. Professional judgment in auditing may be described as the application of relevant knowledge and experience, within the context provided by auditing, accounting and ethical standards, in reaching decisions where a choice must be made between alternative possible courses of action. Informed decisions throughout the audit cannot be made without the application of relevant knowledge and experience to the facts and circumstances, in particular regarding decisions about:

- Materiality and audit risk;
- The nature, timing and extent of audit procedures used to gather audit evidence;
- The review of management's judgments in applying the entity's applicable financial reporting framework; and
- 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.

Professional judgment is therefore essential to the proper conduct of an audit.

- A26. Judgment is essentially a personal quality and may therefore differ between experienced auditors. However, training and experience are intended to promote consistency of judgment such that the exercise of professional judgment in any particular case may be regarded as reasonable if other experienced auditors can agree that this is the case. Any such agreement on whether a judgment is reasonable is based on the facts and circumstances at the time the judgment was made.

Professional Skepticism

- A27. Professional skepticism is an attitude that involves the critical assessment, with a questioning mind, of the validity of audit evidence obtained. It includes recognizing that circumstances may exist that cause the financial statements to be materially misstated, and being alert to audit evidence that contradicts or brings into question the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. Maintaining an attitude of professional skepticism throughout the audit is

necessary if the auditor is, for example, to reduce the risks of overlooking unusual circumstances, of over generalizing when drawing conclusions from audit observations, and of using faulty assumptions in determining the nature, timing and extent of the audit procedures and evaluating the results thereof.

- A28. An audit rarely involves the authentication of documents, nor is the auditor trained as or expected to be an expert in such authentication. Accordingly, unless the auditor has reason to believe the contrary, 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 document have been modified, the auditor may accept records and documents as genuine.

Sufficiency and Appropriateness of Audit Evidence

- A29. 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 and a firm's quality control procedures for client acceptance and continuance. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. Most of the auditor's work in forming the audit opinion consists of obtaining and evaluating audit evidence.
- A30. Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the risks of misstatement (the higher the 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.
- A31. Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for, or detecting misstatements in, the financial statements. 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.
- A32. The sufficiency and appropriateness of audit evidence are interrelated. Whether sufficient appropriate audit evidence has been obtained during the evidence gathering process to enable the auditor to draw reasonable conclusions on which to base the audit opinion is a matter for the auditor to determine using professional judgment.

Materiality and Audit Risk

- A33. Misstatements in the financial statements can arise from fraud or error. The auditor is concerned with material misstatements, but is not responsible for the detection of misstatements that are not material to the financial statements taken as a whole. In general, misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements; The concept of materiality is used both in planning and performing the audit, and in evaluating the effect of identified misstatements on the financial statements and the related auditor's report.

- A34. Audit risk is a function of the risks of material misstatement and detection risk. Assessment of risks is a judgment rather than a precise measurement. The risks of material misstatement may exist at two levels: at the overall financial statement level, and, in relation to classes of transactions, account balances, and disclosures, at the assertion level.
- A35. 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.
- A36. Risks of material misstatement at the class of transactions, account balance, and disclosure level need to be assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This 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 that objective.⁶
- A37. 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.
- A38. 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 measurement 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. In addition to those circumstances that are peculiar to a specific assertion, factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may influence the inherent risk related to a specific assertion. These latter factors include, for example, a lack of sufficient working capital to continue operations or a declining industry characterized by a large number of business failures.
- A39. Control 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.
- A40. 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

⁶ The auditor may make use of a model that expresses the general relationship of the components of audit risk in mathematical terms to arrive at an appropriate level of detection risk. Some auditors find such a model to be useful when planning audit procedures to achieve a desired audit risk though the use of such a model does not eliminate the judgment inherent in the audit process.

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.

- A41. 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. For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessment of the risks of material misstatement at the assertion level. The greater the risks of material misstatement the auditor believes exists, the less the detection risk that can be accepted. Conversely, the less risks of material misstatement the auditor believes exist, the greater the detection risk that can be accepted.
- A42. Detection risk cannot be reduced to zero because of the inherent limitation of an audit and other factors. Such other factors include the possibility that an auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results. These other factors ordinarily can be addressed through adequate planning, proper assignment of personnel to the engagement team, the application of professional skepticism, and supervision and review of the audit work performed.

Ethical Requirements Relating to an Audit of Financial Statements (Ref: Para. 11)

- A43. As discussed in ISA 220, "Quality Control for Audits of Historical Financial Information," ethical requirements relating to audits of financial statements ordinarily comprise Parts A and B of the IFAC Code together with national requirements that are more restrictive.
- A44. ISA 220 identifies the fundamental principles of professional ethics established by Parts A and B of the IFAC Code and sets out the engagement partner's responsibilities with respect to ethical requirements. ISA 220 recognizes that the engagement team is entitled to rely on a firm's systems in meeting its responsibilities with respect to quality control procedures applicable to the individual audit engagement, unless information provided by the firm or other parties suggests otherwise. Accordingly, International Standard on Quality Control (ISQC) 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements," requires the firm to establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements.

Professional Skepticism (Ref: Para. 12)

- A45. A belief that management and those charged with governance are honest and have integrity does not relieve the auditor from maintaining an attitude of professional skepticism or allow the auditor to be satisfied with less-than-persuasive audit evidence.

Conduct of an Audit in Accordance with ISAs

Nature of ISAs (Ref: Para. 13)

- A46. ISAs, taken together, provide the standards for the auditor's work in fulfilling the objective of an audit. 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. The nature of the ISAs requires the auditor to exercise professional judgment in applying them.

A47. 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 ISA, and definitions:

- The objective or objectives in each ISA provide the context in which the requirements of the ISA are set. These objectives support the overall objective of the auditor set out in paragraph 5 of this ISA.
- The requirements (contained in a separate section in each ISA and expressed using the word “shall”) are designed to assist the auditor in meeting the objectives specified in the ISAs and thereby, the overall objective of the auditor.
- The application and other explanatory material 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. When appropriate, additional considerations specific to audits of smaller entities and public sector entities are included within the application material of an ISA.
- 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 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.
- 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 of International Auditing, Assurance, and Ethics Pronouncements published by IFAC contains a complete listing of terms defined in the ISAs. It also includes description of other terms found in ISAs to assist in common and consistent interpretation and translation.

A48. 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.

- A49. In performing an audit, auditors may be required to comply with other professional, legal or regulatory requirements in addition to the ISAs. The ISAs do not override 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.
- A50. The auditor may also conduct the audit in accordance with both ISAs and auditing standards of a specific jurisdiction or country. When the auditor conducts the audit in accordance with ISAs and auditing standards of a specific jurisdiction or country, in addition to complying with each of the ISAs relevant to the audit, 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

- A51. ISAs are relevant to engagements in the public sector. The public sector auditor's responsibilities, however, may be affected by the audit mandate, legislation or regulation, ministerial directives, government policy requirements, or resolutions of the legislature applicable to public sector entities, 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.

Objectives (Ref: Para. 14)

- A52. The objectives in individual ISAs provide a link between the requirements and the overall objective of the auditor, having regard to the need for the auditor to obtain reasonable assurance through gathering sufficient appropriate audit evidence.
- A53. In most circumstances, proper application of the requirements of the ISAs provides a sufficient basis for the auditor's achievement of the objectives. How the requirements are applied and the assessment of whether sufficient appropriate audit evidence has thereby been obtained in the context of the auditor's overall objective are, however, matters of professional judgment. That judgment is made having regard to the fact ISAs are interrelated, in that some ISAs deal with the general responsibilities of the auditor, while others address the auditor's further considerations relevant to the application of those responsibilities to specific topics.

Compliance with Relevant Requirements (Ref: Para. 15(b))

- A54. The auditor is required to comply 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 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 such circumstances, alternative audit procedures need to be performed that achieve the aim of that

requirement. ISA 230, “Audit Documentation” establishes documentation requirements in those circumstances where the auditor departs from a requirement.

A55. A requirement is not relevant only in the cases where:

- (a) The ISA is not relevant (e.g., in a continuing engagement, nothing in ISA 510, “Initial Engagements—Opening Balances,” is relevant); or
- (b) The circumstances envisioned do not apply because the requirement is conditional and the condition does not exist. In general, any conditionality of a requirement will be explicit (e.g., the requirement to modify the auditor’s opinion where there is a limitation of scope). In some cases, it may be implicit (e.g., the communication of material weaknesses in internal control identified during the audit to management and with those charged with governance, which depends on the existence of identified material weaknesses).

The auditor is not required to apply a requirement that is not relevant in the circumstances of the audit; this does not constitute a departure from the requirement.

Appendix

Examples of a Single Financial Statement

- Balance sheet and related explanatory notes.
- Statement of income or statement of operations and related explanatory notes.
- Statement of retained earnings and related explanatory notes.
- Statement of cash flows and related explanatory notes.
- Statement of changes in owners' equity and related explanatory notes.
- Statement of assets and liabilities that does not include owners' equity and related explanatory notes.
- Statement of revenue and expenses and related explanatory notes.
- Statement of operations by product lines and related explanatory notes.
- Statement of cash receipts and disbursements and related explanatory notes.

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