



International Federation of Accountants

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Agenda Item

4

Committee: IAASB

Meeting Location: Sydney

Meeting Date: April 16-20, 2007

Proposed Revised and Redrafted ISA 200

Objective of Agenda Item

1. To approve for exposure proposed ISA 200 (Revised and Redrafted), “Overall Objective of the Independent Auditor, and Concepts Relevant to an Audit of Financial Statements,” revised in response to comments received on second read at the December 2006 IAASB meeting.

Task Force Members

2. The members of the Task Force are as follows:

John Kellas (Chairman)	IAASB Chairman
Denise Esdon	IAASB Deputy Chair
John Fogarty	IAASB Member
Jon Grant	IAASB Technical Advisor
Jim Sylph (ex-officio)	IFAC Executive Director
Gérard Trémolière	IAASB Member

Activities Since Last IAASB Meeting

3. At its December meeting, the IAASB undertook a second read of proposed revised and redrafted ISA 200. The Task Force has revised the proposed ISA in response to comments received, and has undertaken additional drafting in relation to the matters explained below.

Matters for IAASB Consideration

I. THE OBJECTIVE OF AN AUDIT AND ITS RELATIONSHIP TO THE AUDITOR’S OVERALL OBJECTIVE

4. In December, the IAASB discussed the need for, and the placement and content of, material explaining the relationship between the objective of an audit and the auditor’s overall objective. In addition, the IAASB asked that the Task Force consider further how the concept of reducing audit risk (and its relationship to the auditor’s overall objective of obtaining reasonable assurance) could be made more apparent.
5. The Task Force believes that an explanation of the relationship between the objective of an audit and the auditor’s overall objective is important to the understandability of the ISA and therefore should be retained. However, it accepts that such material need not be

presented at the outset of ISA. Accordingly, the Task Force has repositioned the material as Application and Other Explanatory Material in paragraphs A1-A2 of Agenda Item 4-A.

6. In addition, the Task Force has made a small number of editorial changes to clarify references to reasonable assurance and its relationship to the reduction of audit risk to an acceptably low level. Proposed changes are shown in paragraphs 7, 19, A2, A13, A26 and A47 of Agenda Item 4-A.

II. CONCEPTS RELEVANT TO AN AUDIT

7. In December, the IAASB asked that the Task Force reconsider whether the concepts relevant to an audit listed in proposed ISA 200 (Revised and Redrafted) could be presented in a more logical manner.
8. The Task Force believes that a more logical presentation of the concepts can be achieved if the concepts were presented on the basis of the following four general categories:
 - (i) Management responsibilities
 - (ii) Audit concepts
 - (iii) Auditor's responsibilities
 - (iv) Reasonable assurance.
9. Accordingly, the Task Force has re-ordered the list of concepts on the above basis, as presented in paragraph 8 of Agenda Item 4-A. For review purposes, a comparison of the proposed ordering of the concepts with that of the December version of draft revised and redrafted ISA 200 is presented in the Appendix to this Paper.

III. COMPLYING WITH ISAS

10. Paragraph 14 of extant ISA 200 states that the auditor should not represent compliance with ISAs unless the auditor has complied fully with all of the ISAs relevant to the audit. This requirement did not feature in the December version of draft revised and redrafted ISA 200 on the basis that the consequence of a failure to comply with the ISAs should be obvious, and that the requirement featured already in ISA 700 (Revised), "The Independent Auditor's Report on General Purpose Financial Statements."
11. On further consideration, however, the Task Force is of the view that this extant requirement should be retained in revised and redrafted ISA 200. It provides important support for the requirement in paragraph 12 of proposed revised and redrafted ISA 200 for the auditor to comply with all ISAs relevant to the audit. Further, the requirement in ISA 700 (Revised) is presented in relation to audits conducted in accordance with both the ISAs and national standards, and therefore could be interpreted as applicable only in relation to such circumstances. The Task Force therefore recommends that the extant requirement be retained as proposed new paragraph 14 of Agenda Item 4-A.

IV. ACHIEVING OBJECTIVES

12. The October 2005 Exposure Draft of the amended *Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services* (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.”

13. 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 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.”

14. During the discussion of ISA 200 (Revised and Redrafted) at the December meeting, some members suggested that the order in which the elements of paragraph 15 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 (Revised and Redrafted) gave the IAASB the opportunity to provide more explanation to enhance the understanding of the requirements derived from the Preface in this new context. The Task Force accepted this advice.

15. As a result, the Task Force:

- A. *Considered the most appropriate approach to the presentation in ISA 200 (Revised and Redrafted) of the material derived from the amended Preface relating to objectives, and where appropriate has repositioned elements of that material; and*
- B. *Included more essential explanatory material and application and other explanatory material in the draft.*

The Task Force’s specific recommendations are described below.

A. Repositioning of Material

16. The Task Force believes that certain elements of the obligation in paragraph 15 of the amended Preface (see paragraph 13 above) should be repositioned in revised and redrafted 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.

17. Specifically, the Task Force recommends the following:

- a) To move the required consideration of the consequence of failure to achieve an objective immediately after the ‘aim to achieve’ obligation (that is, to present together the first and third sentences of the obligation stated in the amended Preface noted in paragraph 13 above).

This change is shown in paragraph 16 of Agenda Item 4-A; and

- b) To include in ISA 200 (Revised and Redrafted) 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 (Revised and Redrafted), 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 13 above)). The context is further improved by placing this after setting out the obligation to comply with the requirements of ISAs.

These changes are shown in paragraphs 19 and 20 of Agenda Item 4-A.

18. 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.

19. 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*.

20. 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. A consequential change arising from this repositioning is the deletion of the lead-in phrase ‘For this purpose...’ The Task Force does not view this, nor the proposed repositioning, as changing substantively the balance of the obligation relating to the objectives. (It may, however, inadvertently have suggested that this was the only purpose for which the objectives are used, and that they are only effective in the case of ISAs that are concerned with obtaining sufficient appropriate audit evidence. This would not have been a correct inference to be drawn, and the repositioning avoids this risk.)

21. 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. Further, as noted during the February IAASB discussion of draft revised and redrafted ISA 500, it would be desirable to emphasize this requirement in revised and redrafted ISA 200.

The IAASB is asked to advise on the appropriateness of the proposed repositioning of the material noted above?

B. Further Essential Explanatory Material and Application and Other Explanatory Material

22. The Task Force recommends that proposed revised and redrafted ISA 200 contain 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; and
- The consequence of a failure to obtain sufficient appropriate audit evidence.

THE MEANING AND ROBUSTNESS OF THE ‘AIM TO ACHIEVE’ OBLIGATION

23. The Task Force believes that it is important to explain adequately the basis for, and force of, the phrase ‘aim to’ in the obligation for objectives.

24. Accordingly, the Task Force recommends that the application material related to the requirement for the auditor ‘to aim to achieve the objectives’ be amplified to make clear, and explain 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.

25. The Task Force also believes that application material should highlight the fact that the obligation is in fact a robust one, drawing attention in particular to the other requirements of revised and redrafted ISA 200 that reinforce the requirement to aim to achieve the objectives.

26. Proposed changes are shown in paragraph A62 of Agenda Item 4-A.

THE AUDITOR’S CONSIDERATION OF OBJECTIVES

27. 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. The Task Force believes that revised and redrafted ISA 200 would benefit from further explanation of the auditor’s

consideration of the interrelationships among the ISAs. Proposed changes are shown in paragraph A63 of Agenda Item 4-A.

THE CONSEQUENCE OF A FAILURE TO ACHIEVE AN OBJECTIVE

28. 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." The Task Force believes 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). Accordingly, it recommends that revised and redrafted ISA 200 make an explicit statement to this effect – see last sentence of paragraph 16 of Agenda Item 4-A.
29. In support of this proposed statement, the Task Force reviewed the list of draft ISA objectives, an updated version of which is enclosed as Agenda Item 4-B for reference. 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 achieved.¹
30. Accordingly, the Task Force also proposes to introduce application material to explain further this point. ISAs 220 and 230 have been used as examples for this purpose. See paragraphs A64-A66 of Agenda Item 4-A.

THE CONSEQUENCE OF A FAILURE TO OBTAIN SUFFICIENT APPROPRIATE AUDIT EVIDENCE

31. 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, the Task Force believes it appropriate to introduce additional application guidance to assist the auditor in this regard. See paragraph A70 of Agenda Item 4-A.

¹ For example, [proposed] ISA 210 (Redrafted) (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 [proposed] ISA 220 (Redrafted) (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.

The IAASB is asked to advise on the appropriateness of the proposed essential explanatory material and application and other explanatory material noted above, and in particular whether anything more is needed to be said to explain adequately the meaning and effect of the obligation attaching to the objectives.

V. APPLYING, AND COMPLYING WITH, RELEVANT REQUIREMENTS

32. The Task Force is concerned that the relationship between objectives and requirements should be clear. For this purpose, some application and other explanatory material has been moved to essential explanation within the requirements section, and presented in a more balanced way. Thus, the Task Force recommends that additional essential explanatory material be introduced 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 (see paragraph 17 in Agenda Item 4-A); and
- That the requirements cannot anticipate all circumstances and consequently, the auditor may judge it necessary to perform further procedures in pursuance of the objectives (see last sentence of paragraph 18 of Agenda Item 4-A).

VI. INHERENT LIMITATIONS OF AN AUDIT

33. In December, the IAASB noted that the discussion in the ISA of the inherent limitations of an audit seemed unduly to emphasize time and cost considerations. Rather, it was suggested that the discussion should focus on the source and nature of different limitations, and that the use of general categories might be appropriate for this purpose. It was also noted that amplification of the discussion about the limitations arising from the financial reporting framework might be appropriate.

34. The Task Force agrees with these suggestions, and believes that general categories should be used to organize the discussion of inherent limitations. Accordingly, the Task Force recommends that revised and redrafted ISA 200 describe the inherent limitations in the context of the 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 paragraphs A33-A45 of Agenda Item 4-A.

The IAASB is asked to advise on the proposed categories of sources of inherent limitations, including their general description, and the consequential editorial changes proposed in paragraphs A33-A45 of Agenda Item 4-A.

Material Presented (Note: Agenda Item 4-A will be used for purposes of the discussions at the meeting.)

Agenda Item 4-A (Pages 911– 934)	Proposed ISA 200 (Revised and Redrafted) (Mark-up from December IAASB Meeting)
Agenda Item 4-B (Pages 935 – 942)	Draft ISA Objectives (Updated March 1, 2007) (for reference; <i>see note below</i>)
Agenda Item 4-C (Pages 943 – 968)	Mapping Document – Source of Material in Proposed ISA 200 (Revised and Redrafted), and Edits Thereto (for reference)
Agenda Item 4-D (Pages 969 – 986)	Mapping Document – Amended Preface and Extant ISA 200 (for reference)

Action Requested

The IAASB is asked to approve proposed ISA 200 (Revised and Redrafted) for issue as an exposure draft.

The IAASB is also asked to note that the Task Force is contemplating that an updated list of draft ISA objectives shown in Agenda Item 4-B be made available as a supplement (with appropriate caveats) to the proposed ISA 200 (Revised and Redrafted) exposure draft in order to assist respondents in considering that document.

Appendix**Concepts Relevant to an Audit of Financial Statements**

Recommended (as per paragraph 8 of Agenda Item 4-A)	Per December draft ISA 200, for reference
<p>“Management’s responsibilities”</p> <p>(a) – Responsibility for the financial statements</p>	<p>(a) – Independence and ethical behavior</p>
<p>“Audit concepts”</p> <p>(b) – Materiality</p> <p>(c) – Audit risk</p> <p>(d) – Sufficiency and appropriateness of audit evidence</p>	<p>(b) – Responsibility for the financial statements</p> <p>(c) – Reasonable assurance, and the inherent limitations of an audit</p> <p>(d) – Professional judgment</p>
<p>“Auditor’s responsibilities”</p> <p>(e) – Auditor independence and ethical behavior</p> <p>(f) – Professional judgment</p> <p>(g) – Professional skepticism</p>	<p>(e) – Professional skepticism</p> <p>(f) – Sufficiency and appropriateness of audit evidence</p> <p>(g) – Materiality and audit risk</p>
<p>“Reasonable assurance”</p> <p>(h) – Inherent limitations of an audit</p> <p>(i) – Reasonable assurance</p>	

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