Auditing and Assurance Standard **AUS 202**

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Objective and General Principles Governing an Audit of a Financial Report

Prepared by the **Auditing & Assurance Standards Board** of the **Australian Accounting Research Foundation**

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The Australian Accounting Research Foundation was established by CPA Australia and The Institute of Chartered Accountants in Australia, and undertakes a range of technical and research activities on behalf of the accounting profession as a whole. A major responsibility of the Foundation is the development of Australian Auditing and Assurance Standards and Statements.

Auditing and Assurance Standards contain the basic principles and essential procedures identified in bold-type (black lettering) which are mandatory, together with related guidance. For further information about the responsibility of members for compliance with AUSs refer Miscellaneous Professional Statement APS 1.1 "Conformity with Auditing Standards".

Australian Accounting Research Foundation
Level 10,
600 Bourke Street
Melbourne Victoria 3000
AUSTRALIA

Phone: (03) 9641 7433
Fax: (03) 9602 2249
E-mail: standard@aarf.asn.au
Website: www.aarf.asn.au

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AUDITING AND ASSURANCE STANDARD

AUS 202 "OBJECTIVE AND GENERAL PRINCIPLES GOVERNING AN AUDIT OF A FINANCIAL REPORT"

CONTENTS

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MAIN FEATURES OF THE STANDARD

This Auditing and Assurance Standard (AUS) establishes standards and provides guidance regarding the objective and general principles governing an audit of a financial report. The AUS:

(a) requires the auditor to comply with the ethical requirements of CPA Australia and The Institute of Chartered Accountants in Australia;

(b) requires the auditor to conduct an audit in accordance with AUSs;

(c) requires that the audit procedures to conduct an audit be determined by having regard to the requirements of the AUSs, relevant professional bodies, legislation, regulations and, where appropriate, the terms of the audit engagement and reporting requirements;

(d) emphasises that the auditor is responsible for providing reasonable assurance that the financial report taken as a whole is free from material misstatement;

(e) emphasises that the responsibility for preparing and presenting the financial report with the applicable financial reporting framework is that of management of the entity, with oversight from those charged with governance.

AUS 202 "OBJECTIVE AND GENERAL PRINCIPLES GOVERNING AN AUDIT OF A FINANCIAL REPORT"

Introduction

.01 The purpose of this Auditing and Assurance Standard (AUS) is to establish standards and provide guidance on the objective and general principles governing an audit of a financial report. This AUS is to be read in conjunction with AUS 106, "Explanatory Framework for Standards on Audit and Audit Related Services."

Objective of an Audit

.02 ***The objective of an audit of a financial report is to enable the auditor to express an opinion whether the financial report is prepared, in all material respects, in accordance with an 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.

.03 Although the auditor's opinion enhances the credibility of the financial report, the user cannot assume that the audit 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

.04 ***The auditor should comply with the ethical requirements of CPA Australia and The Institute of Chartered Accountants in Australia.*** 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 behaviour; and

(g) Technical standards.

.05 ***The auditor should conduct an audit in accordance with AUSs***. These contain basic principles and essential procedures together with related guidance in the form of explanatory and other material.

.06 ***The auditor should plan and perform an audit with an attitude of professional scepticism recognising that circumstances may exist that cause the financial report to be materially misstated.*** An attitude of professional scepticism 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 scepticism is necessary throughout the audit process for the auditor to reduce the risk of overlooking suspicious circumstances, of over generalising 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.

Scope of an Audit

.07 The term "scope of an audit" refers to the audit procedures deemed necessary in the circumstances to achieve the objective of the audit. ***The audit procedures required to conduct an audit in accordance with AUSs should be determined by the auditor having regard to the requirements of AUSs, relevant professional bodies, legislation, regulations and, where appropriate, the terms of the audit engagement and reporting requirements.***

Reasonable Assurance

.08 An audit in accordance with AUSs is designed to provide reasonable assurance that the financial report taken as a whole is 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 report taken as a whole. Reasonable assurance relates to the whole audit process.

.09 An auditor cannot obtain absolute assurance because 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 internal control (for example, the possibility of management override or collusion).

- The fact that most audit evidence is persuasive rather than conclusive.

.10 Also, the work undertaken by the auditor to form an audit opinion is permeated by judgement, 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 report.

.11 Further, other limitations may affect the persuasiveness of audit evidence available to draw conclusions on particular assertions[1] (for example, transactions between related parties). In these cases certain AUSs identify specified audit 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.

.12 Accordingly, because of the factors described above, an audit is not a guarantee that the financial report is free of material misstatement.

Audit Risk and Materiality

.13 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.[2] Management is responsible for identifying such risks and responding to them. However, not all risks relate to the preparation of the financial report. The auditor is ultimately concerned only with risks that may affect the financial report.

[1] Paragraphs .15-.18 of AUS 502, "Audit Evidence" discuss the use of assertions in obtaining audit evidence.

[2] Paragraphs .30 - .34 of AUS 402, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," discuss the concept of business risks and how they relate to risks of material misstatement.

.14 The auditor obtains and evaluates audit evidence to obtain reasonable assurance about whether the financial report gives a true and fair view (or is 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 report is materially misstated is known as "audit risk"[3].

.15 ***The auditor should plan and perform the audit to reduce audit risk to an acceptably low level that is consistent with the objective of an audit.*** The auditor reduces audit risk 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. Reasonable assurance is obtained when the auditor has reduced audit risk to an acceptably low level.

.16 Audit risk is a function of the risk of material misstatement of the financial report (or simply, the "risk of material misstatement") (i.e., the risk that the financial report is 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 detection risk by performing further audit procedures based on that assessment (see AUS 402, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement" and AUS 406, "The Auditor's Procedures in Response to Assessed Risks"). The audit process involves the exercise of professional judgement 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 AUS 502, "Audit Evidence") and performing audit procedures in response to the assessed risks in order to obtain sufficient appropriate audit evidence.

.17 The auditor is concerned with material misstatements, and is not responsible for the detection of misstatements that are not material to the financial report taken as a whole. The auditor considers whether the effect of identified uncorrected misstatements, both individually and in the aggregate, is material to the financial report taken as a whole. Materiality and audit risk are related (see AUS 306, "Materiality and Audit Adjustments"). In order to design audit procedures to determine whether there are misstatements that are material to the financial report

[3] This definition of audit risk does not include the risk that the auditor might erroneously express an opinion that the financial report is materially misstated.

taken as a whole, the auditor considers the risk of material misstatement at two levels: the overall financial report level and in relation to classes of transactions, account balances, and disclosures and the related assertions.[4]

.18 The auditor considers the risk of material misstatement at the overall financial report level, which refers to risks of material misstatement that relate pervasively to the financial report as a whole and potentially affect many assertions. Risks of this nature often relate to the entity's control environment (although these risks may also relate to other factors, such as declining economic conditions), and are not necessarily risks identifiable with specific assertions at the class of transactions, 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 response to the assessed risk of material misstatement at the overall financial report 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.

.19 The auditor also considers the risk of material misstatement at the class of transactions, 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.[5] The auditor seeks to obtain sufficient appropriate audit evidence at the class of transactions, 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 report taken as a whole at an acceptably low level of

[4] AUS 402, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement" provides additional guidance on the auditor's requirement to assess risks of material misstatement at the financial report level and at the assertion level.

[5] AUS 406, "The Auditor's Procedures in Response to Assessed Risks" provides additional guidance on the requirement for the auditor to design and perform further audit procedures in response to the assessed risks at the assertion level.

audit risk. Auditors use various approaches to accomplish that objective.[6]

.20 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 misstatement that could be material, either individually or when aggregated with other misstatements, 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 that are subject to significant measurement uncertainty pose greater risks than do accounts consisting of relatively routine, factual data. 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 characterised by a large number of business failures.

- "Control risk" is 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. 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 report. Some control risk will always exist because of the inherent limitations of internal control.

[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 judgement inherent in the audit process.

.21 Inherent risk and control risk are the entity's risks; they exist independently of the audit of the financial report. 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 judgement, rather than a precise measurement of risk. When the auditor's assessment of the risk of material misstatement includes an expectation of the operating effectiveness of controls, the auditor performs tests of controls to support the risk assessment. The AUSs 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 AUSs 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 expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

.22 "Detection risk" is the risk that the auditor will not detect a misstatement that exists in an assertion that could be material, either individually or when aggregated with other misstatements. Detection risk is a function of the effectiveness of an audit procedure and of its application by the auditor. Detection risk cannot be reduced to zero because the auditor usually does not examine all of a class of transactions, account balance, or disclosure and because of 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 scepticism, and supervision and review of the audit work performed.

.23 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. For a given level of audit risk, the acceptable level of 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 exists, the greater the detection risk that can be accepted.

Responsibility for the Financial Report

.24 While the auditor is responsible for forming and expressing an opinion on the financial report, the responsibility for preparing and presenting the financial report in accordance with the applicable financial reporting framework is that of the management of the entity, with oversight from those charged with governance. The audit of the financial report does not relieve management or those charged with governance of their responsibilities.

Operative Date

.25 This AUS is operative for financial reporting periods commencing on or after 15 December 2004, although earlier application is encouraged.

Compatibility with International Standards on Auditing

.26 The basic principles and essential procedures of this AUS are identical to those of the International Standard on Auditing ISA 200, "Objective and General Principles Governing an Audit of Financial Statements". The text of ISA 200 has been amended to incorporate in this AUS, terminology and references used in Australian Auditing and Assurance Standards and other Australian professional pronouncements.

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BACKGROUND TO REVISION

This section does not form part of the standard. It is a summary of the reasons for the current revision to the Standard and of key issues which have been considered by the Auditing & Assurance Standards Board (AuASB) as part of this revision.

1. This Auditing and Assurance Standard AUS 202 "Objective and General Principles Governing an Audit of a Financial Report" replaces the former AUS 202, issued in July 2002.

2. The revised AUS 202 includes the revised 'Audit Risk Model'. Expanded guidance has been added primarily to clarify the description of the 'risk of material misstatement'.

3. The revised AUS 202 is based on the revised International Standard on Auditing (ISA) 200 "Objective and General Principles Governing an Audit of Financial Statements", which was issued by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountant (IFAC) in late 2003.

4. The revision to AUS 202 was undertaken as part of an Audit Risk Project to assist auditors in their risk assessments and enhance the design and performance of audit procedures to respond to these risks. Three other revised/new AUSs (ISAs) have also been concurrently released as part of the project, namely AUS 402 (ISA 315) "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement", AUS 406 (ISA 330) "The Auditor's Procedures In Response to Assessed Risks" and AUS 502 (ISA 500) "Audit Evidence". The AuASB recommends that the revised AUS 202 be read in conjunction with AUS 402, AUS 406 and AUS 502.

5. The above revised/new AUSs (ISAs) will later this year replace AUS 214 (ISA 401) "Auditing in a CIS Environment", AUS 304 (ISA 310) "Knowledge of the Business", AUS 402 (ISA 400) "Risk Assessments and Internal Controls" and AUS 502 (ISA 500) "Audit Evidence". These existing AUSs (ISAs) remain operative for financial reporting periods commencing prior to the operative date of the revised/new AUSs (ISAs), namely 15 December 2004.