EXPOSURE DRAFT

ED 8/05
(October 2005)

Proposed Auditing Standard: Objective and General Principles Governing an Audit of a Financial Report (Re-issuance of AUS 202)

Prepared and Issued by the **Auditing and Assurance Standards Board**

Australian Government
Auditing and Assurance Standards Board

Commenting on this Exposure Draft

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A copy of all non-confidential submissions will be placed on public record on the AUASB website: www.auasb.gov.au.

Obtaining a Copy of this Exposure Draft

This Exposure Draft is available on the AUASB website: www.auasb.gov.au. Alternatively, any individual or organisation may obtain one printed copy of this Exposure Draft without charge until 15 December 2005 by contacting:

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PREFACE

Reasons for Issuing ED 8/05

The Auditing and Assurance Standards Board (AUASB) is proposing to re-issue Auditing Standard (AUS 202) *Objective and General Principles Governing an Audit of a Financial Report* due to the requirements of the legislative provisions explained below.

The *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (the CLERP 9 Act) established the AUASB as an independent statutory body under section 227A of the *Australian Securities and Investments Commission Act 2001*, as from 1 July 2004. Under section 336 of the *Corporations Act 2001*, the AUASB may make Auditing Standards for the purposes of the corporations legislation. These Auditing Standards will be legislative instruments under the *Legislative Instruments Act 2003.*

Main Proposals

This proposed Auditing Standard:

(a) sets out the objective of an audit of a financial report;

(b) requires the auditor to comply with relevant ethical requirements relating to audit engagements;

(c) requires the auditor to conduct an audit in accordance with Auditing Standards;

(d) requires the auditor to comply with each of the relevant mandatory requirements of the Auditing Standards relevant to the circumstances of the audit in determining the audit procedures to be performed in conducting an audit in accordance with Auditing Standards and to not represent compliance with Auditing Standards unless all of the Auditing Standards relevant to the audit have been complied with;

(e) requires the auditor to, if possible, perform appropriate alternative procedures and document certain matters where, in rare and exceptional circumstances, factors outside the auditor's control prevent the auditor from complying with a relevant mandatory requirement. Where the auditor is unable to perform appropriate alternative procedures, the auditor is required to consider the implications for the auditor's report;

(f) requires the auditor to exercise professional judgement and to maintain an attitude of professional scepticism throughout the conduct of the audit;

(g) requires the auditor to seek to obtain reasonable assurance as to whether the financial report taken as a whole is free from material misstatement, whether due to fraud or error;

(h) requires the auditor to reduce audit risk to an acceptably low level that is consistent with the objective of an audit; and

(i) requires the auditor to determine the acceptability of the financial reporting framework adopted by management in the preparation of the financial report and to consider implications in relation to the audit when the financial reporting framework is concluded not to be acceptable.

(j) Requires the auditor to perform alternative procedures where in rare and exceptional circumstances, factors outside the auditor's control prevent the auditor from complying with a relevant mandatory requirement.

Proposed Operative Date

It is intended that this proposed Auditing Standard will be operative for financial reporting periods commencing on or after 1 July 2006.

Main changes from existing AUS 202 (February 2004)

The main differences between this proposed Auditing Standard and the Auditing Standard issued by the former Auditing & Assurance Standards Board of the Australian Accounting Research Foundation that it supersedes, (AUS 202) *Objectives and General Principles Governing an Audit of a Financial Report* (February 2004), is that in this proposed Auditing Standard:

1. the word 'shall', in the **bold-type** paragraphs, is the terminology used to describe an auditor's mandatory requirements, whereas an auditor's degree of responsibility was previously described by the word 'should';

2. the explanatory paragraphs provide guidance and illustrative examples to assist the auditor in fulfilling the mandatory requirements, whereas previously some obligations were implied within certain explanatory paragraphs. Accordingly, such paragraphs have been redrafted to clarify that the matter forms part of the explanatory guidance;

3. the following implied obligation, previously in AUS 202, has been elevated and re-stated as a specific mandatory requirement:

    (a) the auditor shall seek to obtain reasonable assurance as to whether the financial report taken as a whole is free from material misstatement, whether due to fraud or error, when conducting an audit in accordance with Auditing Standards (paragraph 24).

    Wording of the requirement has been revised to align to ISA 200 Amended as a Result of ISA 700 (Revised), "Objectives and General Principles Governing an Audit of a Financial Report" ("revised ISA 200");

4. a mandatory requirement and explanatory paragraphs, in relation to professional judgement are adopted (paragraph's 20-23);

5. the requirements and explanatory paragraphs in the revised ISA 200 on the "Ethical Requirements Relating to an Audit of a Financial Report", "Determining the Acceptability of the Financial Reporting Framework" and "Expressing an Opinion on a Financial Report" are adopted and adapted, where appropriate, to the context of this Auditing Standard (paragraphs 8, 9, 46-62);

6. the requirements and explanatory paragraphs on the "Scope of an Audit", previously in AUS 202, have been re-structured to form two separate parts, "Conduct of an Audit of a Financial Report" and "Scope of an Audit of a Financial Report" to reflect the new structure in the revised ISA 200. Additional guidance in the revised ISA 200 are also adopted and adapted, where appropriate, to the context of this Auditing Standard (paragraphs 14-19, excluding paragraph 16); and

7. a mandatory requirement in relation to rare and exceptional circumstances where factors outside the auditor's control prevent the auditor from complying with a relevant mandatory requirement has been included (paragraph 16).

A Table of Proposed Changes is provided as an attachment to the Exposure Draft.

Request for Comments

Comments are invited on this Exposure Draft of the proposed re-issuance of Auditing Standard (AUS 202) *Objectives and General Principles Governing an Audit of a Financial Report* by 15 December 2005. The AUASB would prefer that respondents express a clear overall opinion on whether the proposed Auditing Standard, as a whole, is supported and that this opinion be supplemented by detailed comments, whether supportive or critical, on any matter. The AUASB regards both critical and supportive comments as essential to a balanced review of the proposed Auditing Standard.

AUTHORITY STATEMENT

The Auditing and Assurance Standards Board (AUASB) makes Auditing Standard *Objective and General Principles Governing an Audit of a Financial Report* as set out in paragraphs 1 to 63, pursuant to section 227B of the *Australian Securities and Investment Commission Act 2001* and section 336 of the *Corporations Act 2001*.

This Auditing Standard is to be read in conjunction with the *Preamble to AUASB Standards*, which sets out the AUASB's intentions on how the Auditing Standards are to be understood, interpreted and applied.

The mandatory requirements of this Auditing Standard are set out in **bold-type** paragraphs.

AUDITING STANDARD

Objective and General Principles Governing an Audit of a Financial Report

Application

1 **This Auditing Standard applies to:**

(a) **an audit of a financial report for a financial year, or an audit of a financial report for a half-year, in accordance with Part 2M.3 of the *Corporations Act 2001*; and**

(b) **an audit of a financial report for any other purpose.**

2 This Auditing Standard also applies, as appropriate, to an audit of other financial information.

Operative Date

3 **This Auditing Standard is operative for financial reporting periods commencing on or after 1 July 2006.**

Introduction

4 The purpose of this Auditing Standard is to establish mandatory requirements and provide explanatory guidance on the objective and general principles governing an audit of a financial report. It also describes management's responsibility for the preparation and presentation of the financial report and for identifying the financial reporting framework to be used in preparing the financial report, referred to in the Auditing Standards as the "applicable financial reporting framework."

Objective of an Audit of a Financial Report

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

6 In Australia, an applicable financial reporting framework that may be used in preparing a financial report is represented by the Accounting Standards promulgated by the Australian Accounting

Standards Board (AASB) and relevant legislation, such as the *Corporations Act 2001*, for entities covered by that Act, or other relevant legislation that may be applicable to other entities.

7 Pursuant to paragraph 24 of this Auditing Standard, in conducting an audit, the auditor is required by Auditing Standards to seek to obtain reasonable assurance to enable the auditor to express a positive form of opinion, as to whether the financial report is prepared, in all materials respects, in accordance with the applicable financial reporting framework.

Ethical Requirements Relating to an Audit of a Financial Report

8 The auditor shall comply with relevant ethical requirements relating to audit engagements.

9 As discussed in AUS 206, "Quality Control for Audits of a Financial Report", relevant ethical requirements relating to audits of a financial report ordinarily comprise the applicable code of conduct of a professional accounting body[1]. AUS 206 identifies the fundamental principles of professional ethics established by the applicable code of conduct of a professional accounting body and sets out the engagement partner's responsibilities with respect to relevant ethical requirements relating to audit engagements. AUS 206 recognises that, unless information provided by the firm or other parties suggests otherwise, 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, for example, in relation to:

- capabilities and competence of personnel through their recruitment and formal training;
- independence through the accumulation and communication of relevant independence information;
- maintenance of client relationships through acceptance and continuance systems; and

[1] In Australia, the codes of conduct of the professional accounting bodies, as issued from time to time, are:
- CPA Australia and The Institute of Chartered accountants in Australia, *Joint Code of Professional Conduct*; and
- National Institute of Accountants, *Pronouncements of the Board of Directors – Code of Ethics.*

- adherence to regulatory and legal requirements through the monitoring process.

Accordingly, the quality control requirements for firms issued by a professional accounting body require 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.

General Principles Governing an Audit of a Financial Report

Conduct of an Audit of a Financial Report

10 The auditor shall conduct an audit in accordance with Auditing Standards.

11 The requirements of Auditing Standards set out in bold-type paragraphs contain basic principles and essential procedures that are mandatory. The explanatory paragraphs and any appendices in Auditing Standards, provide guidance and illustrative examples to assist auditors in the application of the mandatory requirements.

12 In conducting an audit in accordance with Auditing Standards, the auditor is ordinarily aware of and considers Auditing Guidance Statements (AGSs) applicable to the audit engagement. AGSs provide interpretive guidance and practical assistance to auditors in implementing Auditing Standards.

13 The auditor may also conduct the audit in accordance with both Australian Auditing Standards and auditing standards of a specific jurisdiction or country.

Scope of an Audit of a Financial Report

14 The term "scope of an audit" refers to the audit procedures that, in the auditor's judgement and based on the Auditing Standards, are deemed appropriate in the circumstances to achieve the objective of the audit.

15 In determining the audit procedures to be performed in conducting an audit in accordance with Auditing Standards, the auditor shall comply with each of the Auditing Standards relevant to the audit.

16 Where in rare and exceptional circumstances, factors outside the auditor's control prevent the auditor from complying with a relevant mandatory requirement, the auditor shall:

(a) if possible, perform appropriate alternative procedures; and

(b) in accordance with AUS 208, document in the working papers:

(i) the circumstances surrounding the inability to comply;

(ii) the reasons for the inability to comply; and

(iii) justification of how alternative procedures achieve the objectives of the mandatory requirement.

When the auditor is unable to perform appropriate alternative procedures, the auditor shall consider the implications for the auditor's report.

17 In performing an audit, auditors may be required to comply with other professional, legal or regulatory requirements in addition to the Auditing Standards. In the event that these other requirements differ from those in the Auditing Standards, an audit conducted in accordance with other professional, legal or regulatory requirements does not, of itself, represent compliance with Auditing Standards.

18 When the auditor conducts the audit in accordance with Australian Auditing Standards and auditing standards of a specific jurisdiction or country, in addition to complying with each of the Auditing Standards relevant to the audit, pursuant to AUS 702, the auditor is required to perform any additional audit procedures necessary to comply with the relevant auditing standards of that jurisdiction or country.

19 The auditor shall not represent compliance with Auditing Standards unless the auditor has complied fully with all of the Auditing Standards relevant to the audit.

Professional Judgement and Professional Scepticism

20 The auditor shall plan and perform an audit by exercising professional judgement.

21 The auditor shall 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.

22 The professional judgement of an auditor emanates from characteristics such as the auditor's expertise, experience, knowledge and training. In exercising professional judgement when conducting an audit of a financial report, the auditor considers a number of factors which may influence the auditor's decision on the planning, performance and reporting aspects of the audit. Such factors may include audit objectives, the nature of the subject matter(s) subject to audit, expectations, practicality, sufficiency and appropriateness of audit evidence, reliability of information and alternative audit tools and techniques. When exercising professional judgement, the auditor maintains independence and objectivity, and adopts an attitude of professional scepticism in order to achieve the audit objectives.

23 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 and responses to inquiries and other information obtained from management and those charged with governance. For example, an attitude of professional scepticism is necessary throughout the audit process for the auditor to reduce the risk of overlooking unusual 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. When making inquiries and performing other audit procedures, the auditor is not satisfied with less-than-persuasive audit evidence based on a belief that management and those charged with governance are honest and have integrity. 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 auditor's opinion.

Reasonable Assurance

24 The auditor shall seek to obtain reasonable assurance as to whether the financial report taken as a whole is free from material misstatement, whether due to fraud or error, when conducting an audit in accordance with Auditing Standards.

25 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.

26 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 following:

- the use of testing;
- the inherent limitations of internal control (for example, the possibility of management override or collusion); and
- the fact that most audit evidence is persuasive rather than conclusive.

27 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.

28 Further, other limitations may affect the persuasiveness of audit evidence available to draw conclusions on particular assertions[2] (for example, transactions between related parties). In these cases, certain Auditing Standards 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.

29 Accordingly, because of the factors described above, an audit is not a guarantee that the financial report is free from material misstatement, because absolute assurance is not attainable. Further, an audit opinion does not assure the future viability of the entity nor

2 See AUS 502 for further guidance in relation to the use of assertions in obtaining audit evidence.

the efficiency or effectiveness with which management has conducted the affairs of the entity.

Audit Risk and Materiality

30 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.[3] 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.

31 Pursuant to AUS 502, "Audit Evidence", the auditor is required to obtain and evaluate 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."[4]

32 The auditor shall plan and perform the audit to reduce audit risk to an acceptably low level that is consistent with the objective of an audit.

33 Pursuant to AUS 406, "The Auditor's Procedures in Response to Assessed Risks", the auditor is required to reduce 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.

34 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"). Pursuant to AUS 402 and AUS 406, the auditor is required to perform audit procedures to assess the risk of material misstatement and to seek to limit detection risk by performing

[3] See AUS 402 , "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," for further guidance in relation to the concept of business risks and their relationship to (or relation with) risks of material misstatement.

[4] 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.

further audit procedures based on that assessment. 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 for further guidance) and performing audit procedures in response to the assessed risks in order to obtain sufficient appropriate audit evidence (see AUS 406 for further guidance).

35 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. Pursuant to AUS 306, "Materiality and Audit Adjustments", the auditor is required to consider 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 for further guidance). In order to design audit procedures to determine whether there are misstatements that are material to the financial report taken as a whole, pursuant to AUS 402, the auditor is required to consider the risk of material misstatement at two levels: the overall financial report level and the assertion level for:

- classes of transactions;
- account balances; and
- disclosures and the related assertions.[5]

36 Pursuant to AUS 402, the auditor is required to consider the risk of material misstatement at the overall financial report level, which refers to the risk of material misstatement that relates pervasively to the financial report as a whole and potentially affects many assertions. Risk of this nature often relates to the entity's control environment (although this risk may also relate to other factors, such as declining economic conditions), and is not necessarily risk 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 risk 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 ordinarily includes consideration of the

[5] See AUS 402 for further guidance in relation to the auditor's requirement to assess risks of material misstatement at the financial report level and at the assertion level.

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.

37 Pursuant to AUS 402, the auditor is required to consider 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.[6] The auditor ordinarily 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 audit risk. The auditor ordinarily uses various approaches to accomplish that objective.[7]

38 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

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[6] See AUS 406 for further guidance in relation to the requirement for the auditor to design and perform further audit procedures in response to the assessed risks at the assertion level.

[7] 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.

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.

39 Inherent risk and control risk are the entity's risks; they exist independently of the audit of the financial report. Pursuant to AUS 406, 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, pursuant to AUS 406, the auditor is required to perform tests of controls to support the risk assessment. The Auditing Standards 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 Auditing Standards 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.

40 "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 ordinarily 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.

41 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

42 While the auditor is responsible for forming and expressing an opinion on the financial report, the responsibility for the preparation and presentation of the financial report in accordance with the applicable financial reporting framework is that of the management[8] of the entity, with oversight from those charged with governance[9]. The audit of the financial report does not relieve management or those charged with governance of their responsibilities.

43 The term "financial report" refers to a structured representation of the financial information, which ordinarily includes accompanying

[8] The term "management" has been used in this standard to describe those responsible for the preparation and presentation of the financial report. Other terms may be appropriate depending on the legal framework in the particular jurisdiction.

[9] The structures of governance vary from country to country, reflecting cultural and legal backgrounds. Therefore, the respective responsibilities of management and those charged with governance vary depending on the legal responsibilities in the particular jurisdiction.

notes, derived from accounting records and 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 may refer to a complete financial report, but in some jurisdictions, it may also refer to a single financial statement, for example, a balance sheet, or a statement of revenues and expenses, and related explanatory notes.

44 The requirements of the financial reporting framework determine the form and content of the financial report and what constitutes a complete financial report. For certain financial reporting frameworks, a single financial statement such as a cash flow statement and the related explanatory notes constitutes 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. A financial report prepared by reference to Australian Accounting Standards, on the other hand, is intended to provide information about the financial position, performance and cash flows of an entity. A complete financial report as defined under sections 295 and 303 of the *Corporations Act 2001* and AASB 101, "Presentation of Financial Statements", consists of the financial statements for the year and the half-year respectively, notes to the financial statements and the directors' declaration about the statements and notes.

45 Management is responsible for identifying the financial reporting framework to be used in the preparation and presentation of the financial report. Management is also responsible for preparing and presenting the financial report in accordance with that applicable financial reporting framework. This responsibility includes:

- designing, implementing and maintaining internal control relevant to the preparation and presentation of a financial report that is free from material misstatement, whether due to fraud or error;
- selecting and applying appropriate accounting policies; and
- making accounting estimates that are reasonable in the circumstances.

Determining the Acceptability of the Financial Reporting Framework

46 The auditor shall determine whether the financial reporting framework adopted by management in preparing the financial report is acceptable.

47 The auditor ordinarily makes this determination when considering whether to accept the audit engagement, as discussed in AUS 204, "Terms of Audit Engagements." An acceptable financial reporting framework is referred to in the Auditing Standards as the "applicable financial reporting framework."

48 The auditor ordinarily determines whether the financial reporting framework adopted by management is acceptable in view of the nature of the entity (for example, whether it is a business enterprise, a public sector entity or a not for profit organisation) and the objective of the financial report.

Financial Reports Designed to Meet the Financial Information Needs of Specific Users

49 In some cases, the objective of the financial report will be to meet the financial information needs of specific users. The information needs of such users will determine the applicable financial reporting framework in these circumstances. Examples of financial reporting frameworks that address the needs of specific users are:

- a cash receipts and disbursements basis of accounting;
- the financial reporting provisions of a government regulatory agency for a financial report to meet the information needs of that agency; or
- a financial reporting framework established by the provisions of an agreement specifying the financial report to be prepared.

Financial reports prepared in accordance with such financial reporting frameworks may be the only financial reports prepared by an entity and, in such circumstances, are often used by users in addition to those for whom the financial reporting framework is designed. Despite the broad distribution of the financial reports in those circumstances, the financial reports are still considered to be designed to meet the financial information needs of specific users for purposes of the Auditing Standards. AUS 802, "The Auditor's

Report on Financial Information Other Than a General Purpose Financial Report", establishes standards and provides guidance on financial reports whose objective is to meet the financial information needs of specific users.

Financial Reports Designed to Meet the Common Financial Information Needs of a Wide Range of Users

50 Many users of financial reports are not in a position to demand financial reports tailored to meet their specific information needs. While all the information needs of specific users cannot be met, there are financial information needs that are common to a wide range of users. Financial reports prepared in accordance with a financial reporting framework that is designed to meet the common information needs of a wide range of users are referred to as "general purpose financial reports."

Financial Reporting Frameworks Established by Authorised or Recognised Organisations

51 At present, there is no objective and authoritative basis that has been generally recognised globally for judging the acceptability of financial reporting frameworks that have been designed for general purpose financial reports. Until such a basis exists, financial reporting frameworks established by organisations that are authorised or recognised to promulgate standards to be used by certain types of entities are presumed to be acceptable for general purpose financial reports prepared by such entities provided the organisations follow an established and transparent process involving deliberation and consideration of the views of a wide range of stakeholders. Examples of such financial reporting frameworks include:

- Accounting Standards promulgated by the AASB and other mandatory financial reporting requirements in Australia;
- International Financial Reporting Standards and International Accounting Standards promulgated by the International Accounting Standards Board;
- IPSASs promulgated by the International Federation of Accountants – International Public Sector Accounting Standards Board; and
- generally accepted accounting principles promulgated by a recognised standards setter in a particular jurisdiction.

These financial reporting frameworks are often identified as the applicable financial reporting framework in legislative and regulatory requirements governing the preparation of general purpose financial reports.

Financial Reporting Frameworks Supplemented with Legislative and Regulatory Requirements

52 In some jurisdictions, legislative and regulatory requirements may supplement a financial reporting framework adopted by management with additional requirements relating to the preparation and presentation of financial reports. In these jurisdictions, the applicable financial reporting framework, for the purposes of applying the Auditing Standards, encompasses both the identified financial reporting framework and such additional requirements, provided they do not conflict with the applicable financial reporting framework. This may, for example, be the case when additional requirements prescribe disclosures in addition to those required by the identified financial reporting framework or when they narrow the range of acceptable choices that can be made within the identified financial reporting framework. If the additional requirements conflict with the applicable financial reporting framework, the auditor ordinarily discusses the nature of the requirements with management and whether the additional requirements can be met through additional disclosures. If this is not possible, pursuant to AUS 702, "The Audit Report on a General Purpose Financial Report", the auditor is required to consider whether it is necessary to modify the auditor's report.

Jurisdictions that Do Not have an Authorised or Recognised Standards Setting Organisation

53 When an entity is registered or operating in a jurisdiction that does not have an authorised or recognised standards setting organisation, the entity identifies an applicable financial reporting framework. Practice in such jurisdictions is often to use a financial reporting framework established by one of the organisations described in paragraph 51. Alternatively, there may be established accounting conventions in a particular jurisdiction that are generally recognised as the applicable financial reporting framework for the general purpose financial reports prepared by certain specified entities operating in that jurisdiction. When such a financial reporting framework is adopted by the entity, pursuant to paragraph 46 of this Auditing Standard, the auditor is required to determine whether the accounting conventions collectively can be considered to constitute an acceptable financial reporting framework for general purpose financial reports. When the accounting conventions are widely used

in a particular jurisdiction, the accounting profession in that jurisdiction may have considered the acceptability of the financial reporting framework on behalf of the auditors. Alternatively, the auditor ordinarily makes this determination by considering whether the accounting conventions exhibit attributes normally exhibited by acceptable financial reporting frameworks or by comparing the accounting conventions to the requirements of an existing financial reporting framework considered to be acceptable.

Attributes of an Acceptable Financial Reporting Framework

54 Acceptable financial reporting frameworks for a general purpose financial report normally exhibit the following attributes that result in information provided in a financial report that is useful to users:

(a) relevance, in that the information provided in the financial report is relevant to the nature of the entity and the objective of the financial report. (For example, in the case of a business enterprise that prepares a general purpose financial report, relevance is assessed in terms of the information necessary to meet the common information needs of a wide range of users in making economic decisions. These needs are ordinarily met by presenting fairly the financial position, financial performance and cash flows of the business enterprise);

(b) completeness, in that transactions and events, account balances and disclosures that could affect the fair presentation of the financial report are not omitted;

(c) reliability, in that the information provided in the financial report:

  (i) reflects the economic substance of events and transactions and not merely their legal form; and

  (ii) results in reasonably consistent evaluation, measurement, presentation and disclosure, when used in similar circumstances;

(d) neutrality, in that it contributes to information in the financial report that is free from bias; and

(e) understandability, in that the information in the financial report is clear and comprehensive and not subject to significantly different interpretation.

55 A conglomeration of accounting conventions devised to suit individual preferences is not an acceptable financial reporting framework for financial reports intended to address the common information needs of a wide range of users.

56 The description of the financial reporting framework in the financial report includes information about the basis of preparation of the financial report and the accounting policies selected and applied for significant transactions and other significant events.

57 The auditor may decide to compare the accounting conventions to the requirements of the Accounting Standards promulgated by the AASB. For an audit of a small entity, the auditor may decide to compare such accounting conventions to a financial reporting framework specifically developed for such entities by an authorised or recognised standards setting organisation. When the auditor makes such a comparison and differences are identified, the decision as to whether the accounting conventions adopted by management constitute an acceptable financial reporting framework ordinarily includes consideration of the reasons for the differences and whether application of the accounting conventions could result in financial reports that are misleading.

58 When the auditor concludes that the financial reporting framework adopted by management is not acceptable, the auditor shall consider the implications in relation to engagement acceptance and the auditor's report.

59 See AUS 204 for requirements and guidance in relation to engagement acceptance and AUS 702 for requirements and guidance in relation to the auditor's report.

Expressing an Opinion on a Financial Report

60 When the auditor is expressing an opinion on a general purpose financial report prepared in accordance with a financial reporting framework that is designed to achieve fair presentation, pursuant to paragraph 10 of this Auditing Standard, the auditor is required to refer to AUS 702 for standards and guidance on the matters the auditor considers in forming an opinion on such financial report and on the form and content of the auditor's report. Pursuant to paragraph 10 of this Auditing Standard, the auditor is also required to refer to AUS 702 when expressing a modified audit opinion, including an emphasis of matter, a qualified opinion, an inability to form an opinion or an adverse opinion.

61 The auditor refers to AUS 802 when expressing an opinion on:

(a) special purpose financial reports;

(b) 'other' financial information; and

(c) summarised financial reports.

62 In addition to addressing reporting considerations, AUS 802 also addresses other matters the auditor ordinarily considers in such engagements related to, for example, engagement acceptance and the conduct of the audit.

Conformity with International Standards on Auditing

63 Except as noted below, this Auditing Standard conforms with International Standard on Auditing ISA 200, "Objective and General Principles Governing an Audit of a Financial Report," issued by the International Auditing and Assurance Standards Board of the International Federation of Accountants. The differences between this Auditing Standard and ISA 200 are:

- This Auditing Standard contains the mandatory requirement for the auditor to plan and perform an audit by exercising professional judgement, whereas ISA 200 does not (paragraph 20);
- This Auditing Standard contains the mandatory requirement for the auditor to, if possible, perform appropriate alternative procedures and document certain matters where, in rare and exceptional circumstances, factors outside the auditor's control prevent the auditor from complying with a relevant mandatory requirement. Where the auditor is unable to perform appropriate alternative procedures, the auditor is required to consider the implications for the auditor's report. ISA 200 does not contain this mandatory requirement (paragraph 16); and
- This Auditing Standard contains the mandatory requirement for the auditor to seek to obtain reasonable assurance as to whether the financial report taken as a whole is free from material misstatement. ISA 200 provides guidance only, in the explanatory paragraphs, relating to reasonable assurance (paragraph 24).

Compliance with this Auditing Standard enables compliance with ISA 200.

Table of Proposed Changes from AUS 202
Objective and General Principles Governing An Audit of A Financial Report

Base Standard
ISA 200, "Objective and General Principles Governing an Audit of a Financial Report"," was used as the base standard when re-drafting this proposed Auditing Standard.

Main differences between the Base Standard and the existing AUS 204
The main differences between ISA 200 and the existing AUS 202 are:
1. ISA 200 contains mandatory requirements and explanatory guidance in relation to "Ethical Requirements Relating to an Audit of a Financial Report", "Determining the Acceptability of the Financial Reporting Framework" and "Expressing an Opinion on a Financial Report."

Table of proposed changes from the Base Standard
The table below details the proposed changes from the base standard, ISA 200 (excluding changes to reflect Australian terminology and references to Australian Auditing Standards).

Paragraph No in Proposed Exposure Draft	Status (Requirement, Guidance, Footnote or Appendix)	Description of Proposed Change(s)
1, 2	Requirement / Guidance	New Application Paragraph.
3	Requirement	Insert Operative Date paragraph.
N/A	Guidance	Delete Public Sector Perspective as proposed Auditing Standards will be sector neutral.
8, 10, 15, 19, 21, 24, 32, 46, 58	Requirement	Replace "should" with "shall".
49, 52, 58 59, 60	Requirement / Guidance	Replace "audit report" with "auditor's report".
24	Guidance	Elevate implied obligation to a mandatory requirement.
20, 22	N/A	Insert new requirement and corresponding guidance and header relating to the auditor's exercise of professional judgement during the planning and performance of an audit.

Paragraph No in Proposed Exposure Draft	**Status (Requirement, Guidance, Footnote or Appendix)**	**Description of Proposed Change(s)**
5, 28, 30, 35, 37, 43	Requirement / Footnote	Minor re-write of existing sentence.
12, 36, 37, 40, 48, 52, 53, 57, 62	Guidance	Insert "ordinarily" to clarify implied obligations.
7, 18, 31, 33, 34, 35, 36, 37, 39, 52, 53, 60	Guidance	Insert "pursuant to…the auditor is required to…" to clarify implied obligations.
6	Guidance	Insert guidance on the financial reporting framework applicable to entities in Australia.
7	Guidance	Insert guidance on the definition of an audit.
9, 35, 36, 40, 49	Guidance	Bullet-point examples in guidance.
Before: 10, 35, 54	N/A	Add Header.
11	Grey	Insert guidance on the structure of Auditing Standard as prescribed in the Authority Statement to the Auditing Standards.
13,18	Grey	Add "Australian" before "Auditing Standard".
44	Grey	Insert definition of a financial report (in accordance with the *Corporations Act 2001* and AASB 101, "Presentation of Financial Statements") and reference to half-year financial reports.
51	Grey	Insert Accounting Standards promulgated by the Australian Accounting Standards Board as an example of a financial reporting framework.
59	Grey	Separate guidance from mandatory requirement.
16	Requirement	Insert new requirement relating to rare and exceptional circumstances where factors outside the auditor's control prevent the auditor from complying with a mandatory requirement.