SELECTED ISSUES IN RELATION TO FINANCIAL STATEMENT AUDITS

INHERENT LIMITATIONS, REASONABLE ASSURANCE, PROFESSIONAL JUDGMENT AND ITS DOCUMENTATION, AND ENFORCEABILITY OF AUDITING STANDARDS

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This paper is provided to the European Commission Services (DG MARKT) as a response to its request for consideration of inherent limitations of an audit and the relationship between inherent limitations of an audit and reasonable assurance, professional judgment and its documentation, and the enforceability of auditing standards.

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SECTION 1. EXECUTIVE SUMMARY

1.1. Introduction

1. In this Paper, FEE responds to a request by European Commission Services (DG MARKT) for more information about the inherent limitations of an audit and the relationship between inherent limitations of an audit and reasonable assurance (and its relationship to absolute assurance), professional judgment and the enforceability of auditing standards. This Paper applies a technical approach to analyse these issues. This Paper does not constitute a conceptual framework for audits, but FEE continues to recommend that auditing standards setters and the auditing profession commence work on such a framework at an international level.
2. The Paper addresses a number of contextual issues around the foundations of audits to enable further analysis of the issues, and then addresses the inherent limitations of an audit and their relationship to the other concepts. In particular, it is useful to examine the financial reporting process in which an audit is embedded as a process flow, which can be described as the information supply chain that delivers financial reporting to the market, or the "financial reporting supply chain". The Paper applies the concept of the financial reporting supply chain in its further analysis of the inherent limitations of an audit and develops a categorisation of sources of inherent limitations based upon this perspective. Potential consequences for the International Standards on Auditing (ISAs), and in particular, ISA 200, are addressed towards the end of each Section, when relevant (and towards the end of each Subsection of this Executive Summary, when relevant).

1.2. Value-Added of Audits

3. The focus of this Paper is the inherent limitations of an audit and related issues – in other words, on what audits cannot or should not deliver. A more balanced perspective on inherent limitations of an audit addresses the value-added of audits despite their inherent limitations. However, it is not the purpose of the Paper to provide an exhaustive analysis of the benefits and costs of audits.
4. It should be noted that audit failures need not cause reflection about whether audits as a service (or the entire audit model) need to be called into question, even if major failures may prompt examination of whether improvements can be made. Business failures often ascribed to auditors arise from failed corporate strategies or execution of strategies or corporate governance failures. In large part, the effectiveness of audit systems in society are, or ought to be, determined by political decisions in society about the allocation of resources and obligations in the financial reporting supply chain based on the relative costs and benefits of such allocation.
5. Overall, the brief analysis of the benefits of audits in the Paper appears to indicate that the benefits of audits of financial statements are considerable, both at a financial statement and economic level. This is so even though audits have rather limited effectiveness in the detection of material sophisticated management fraud involving collusion with third parties and the falsification of documents, and even though it is difficult for auditors to determine whether management judgments are reasonable.
6. Based on the analysis in the Paper, despite the inherent limitations of an audit, a strong case can be made that auditors provide a high-value-added service to the other participants in the financial reporting supply chain and hence to the economy as a whole. The fact that audits

provide a high value-added service to the economy should be kept in mind and lend a sense of perspective when reading the Paper and its detailed treatment of the inherent limitations of audits and related issues.

1.3. An Overview of the Nature of Financial Statement Audits

7. Financial statement audits are directed towards the expression of an opinion on whether the financial statements have been prepared in accordance with accounting requirements (including fair presentation or a true and fair view when included in those requirements). Agency theory suggests that when there is information asymmetry between users of financial statements and their preparers about the compliance of the financial statements with accounting requirements, it may be in the interests of financial statement users to have that compliance audited by an independent auditor. Consequently, like the contents of financial statements, the role of audits is "user-driven". Hence, some issues relevant to financial statements are also important for audits. Such issues include:
   - The concept of materiality;
   - That the benefits of providing the financial statements to users need to be worth the costs to those users; and
   - The need to provide the financial statements to the users on a timely basis.
8. Although the role of audits is "user-driven", audits are embedded in the financial reporting supply chain (see above), which limits what an audit can deliver to users, and therefore represents the primary source of inherent limitations of an audit.
9. Agency theory also leads to some premises upon which the performance of an audit is based. In particular, this includes the premise that management is responsible for the preparation of the financial statements in accordance with accounting requirements – not the auditor, who is responsible for expressing an opinion on whether the financial statements comply with those requirements. Another such premise sets forth that management or those charged with governance are responsible for the design, implementation and maintenance of adequate internal control necessary for the preparation of the financial statements in accordance with the accounting requirements. In addition, an audit is also premised upon management being responsible for providing all information to the auditor needed by the auditor to perform the audit. The performance of financial statement audits is predicated upon these premises, irrespective of management's legal responsibilities in this regard.

1.4. Assertions, Materiality, Material Misstatements and Risks of Material Misstatements: Management and Auditor Perspective

10. An understanding of the concepts "financial statement assertions" (see Section 4.2.1) "misstatements" (see Section 4.2.2), and "materiality" and "material misstatements" (see Section 4.2.3), is necessary for an understanding of the concept "risk of material misstatement" (or "misstatement risk" – see Section 4.2.5) and its components "inherent risk" and "control risk". The assertion as to whether the financial statements give a "true and fair view" is – in the first instance – an accounting rather than an auditing issue, because the assertion exists regardless of whether an audit has been performed. As a financial statement assertion, it is, however, also subject to audit when such financial statements are audited.
11. Materiality is also fundamentally an accounting – not an auditing – concept: materiality exists independently of whether an audit is performed, even though the concept of

materiality is central to the performance of an audit. Accounting standards recognise the judgmental nature of the determination of materiality for particular financial statements and recognise that materiality is both a quantitative and qualitative concept. Consequently, accounting standards generally do not provide any specific quantitative guidance for quantitative thresholds of materiality – indeed, qualitative materiality cannot be subjected to any such quantitative guidance. Since materiality for audit purposes ought to be the same as for financial statement purposes, the fact that accounting standards setters have refrained from defining quantitative materiality thresholds for financial statements due to its judgmental nature means that it would be inappropriate for auditing standards setters to do so: they would be exceeding their authority by encroaching upon accounting standards setting.

12. The risk that material misstatements are made in preparing the financial statements (inherent risk) or that controls over that preparation do not prevent, or detect and correct, such errors (control risk) can never, whether individually or collectively, be reduced to zero. Consequently, these risks represent inherent limitations of the financial statements. At the same time these risks represent those risk components, of audit risk, not under the control of the auditor. Hence, an understanding of these concepts and their interrelationships is necessary for a treatment of inherent limitations of an audit, and of audit risk and reasonable assurance. Based upon an analysis of the nature and interrelationship of these concepts, this Paper draws some important conclusions about these concepts that are then applied in further analyses of audit risk and reasonable assurance.

13. In particular, inherent risk is greater for some financial statement assertions than for others. Furthermore, controls are more effective in responding to some kinds of inherent risks than others, which means that control risk is greater for some kinds of inherent risks than for others. Consequently, the risks of material misstatement vary greatly among the financial statement assertions. This is exacerbated by the fact that inherent and control risks are often not completely independent of one another: often assertions with high inherent risks are those that are less susceptible to risk management through control. To the extent that risks of material misstatement for particular assertions in the financial statements are independent of one another, the risk of material misstatement for the financial statements as a whole cannot be less than the risk of material misstatement for the assertion with the greatest such risk (i.e., the financial statements as a whole cannot be better than their weakest link).

14. The audit is directed at mitigating (not reducing – the auditor does not control misstatement risk) the risk of material misstatement by having the auditor assess this risk and then respond to the assessed risk by performing further audit procedures designed to detect such misstatements. By mitigating misstatement risk through the audit, the auditor reduces the risk to users that material misstatements exist in the (audited) financial statements. Because the audit primarily involves the assessment of the risks of material misstatement of financial statement assertions, and further audit procedures to detect such misstatements, the audit process is very much driven by the financial statement assertions that are, and should be, in the financial statements.

1.5. Inherent Limitations of an Audit

15. Clarification of inherent limitations of an audit together with an explanation of reasonable and absolute assurance and their relationship is central to this paper (see paragraphs 1 and 45). Since absolute assurance can only be obtained in an "ideal world", this has been applied in this Paper as the starting point to define inherent limitations of an audit. This necessarily leads to a very broad definition of inherent limitations of an audit, but also serves to provide

a more comprehensive analysis of what audits cannot, and should not, achieve.

16. Regardless of their actual expectations in the real world, in an ideal world, *users of audits would desire from auditors a guarantee for everything associated with the entity right away at no cost.* Needless to say, what users may desire in an ideal world falls short of what audits can, or ought to, deliver in the real world due to the *inherent limitations of an audit*. In other words, the inherent limitations of an audit essentially reflect the real world constraints on what audits can or should deliver. The inherent limitations of an audit primarily arise from limitations imposed by the financial reporting supply chain and relate to resource allocation decisions, based on the relative costs and benefits, that society makes. Hence, the inherent limitations of an audit are not separable from the role of audits in the financial reporting supply chain.

17. General inherent limitations of an audit are those that are pervasive to an audit because they affect many different financial statement assertions, kinds of assertions, or audit issues. General inherent limitations manifest themselves as specific inherent limitations for specific assertions, kinds of assertions or audit issues. It is not possible to draw up an exhaustive list of specific inherent limitations because such a list would literally be endless. However, it is possible to develop comprehensive categorisations of general inherent limitations.

18. There are two basic approaches to the categorisation of general inherent limitations: by control and source, or by audit impact. Each of these approaches has advantages and disadvantages. This Paper concentrates on the categorisation by control and source because FEE believes that this categorisation is of greater interest to audit regulators. The categorisation of general inherent limitations of an audit by ***control and source*** is as follows:

Categorisation of General Inherent Limitations of an Audit By Control and Source

a) General inherent limitations of an audit arising from matters not under the direct control of the auditor
   (i) General inherent limitations arising from the environment surrounding audits and arising from the inputs to the audit process from parts of the financial reporting supply chain other than audits
      - Legal, regulatory or auditing standards requirements defining audit coverage or scope (definition of audit object)
      - Applicable financial reporting framework and entity activities and circumstances generating the audit object: financial statement assertions and related available evidence
      - Legal, regulatory and ethical prohibitions on auditor access to information
      - Inherent limitations on internal control when substantive procedures are not enough
      - Other environmental factors affecting, or other inputs to, the audit process, such as other legal or regulatory requirements for audits
   (ii) General inherent limitations arising from the users that use the outputs from the audit process (user decision-making from audit results)
b) General inherent limitations of an audit arising from constraints on the control exercised by the auditor over audit inputs and the audit process
   (i) General inherent limitations arising from constraints on the inputs brought into the audit process by the auditor
   (ii) General inherent limitations arising from constraints on the audit process as conducted by the auditor.

Section 5.5 in the body of the Paper provides further details necessary for an understanding of each category. From an auditing standards setting perspective – as opposed to the financial reporting supply chain or financial reporting system perspective applied in this Paper – audit coverage or scope (the boundaries delineating what an audit is from what it is

not), as well as user decision-making from audit results – are not regarded as inherent limitations of an audit. From an auditing standards perspective, audit coverage represents the basis for the treatment of the other inherent limitations of an audit.

19. The general inherent limitations arising from matters not under the control of the auditor are imposed directly by other parts of the financial reporting supply chain: in certain cases, an auditor can, and may, seek to mitigate these limitations in varying degrees, but cannot eliminate them. The general inherent limitations arising from constraints on matters over which the auditor has control arise from economic and timing considerations: the auditor has control over these matters, but acts as executor for the participants in the financial reporting supply chain in trying to balance the costs and benefits and timing of the audit among the participants. Nevertheless, these constraints arising from cost, benefit and timing considerations represent real constraints and hence inherent limitations of an audit.

20. FEE believes that the ISAs, and in particular, ISA 200, could address the sources of general inherent limitations and the degree of control that an auditor can exercise over these, and the degree to which the auditor can mitigate them. Mention should be made of the limitations on auditor access to information and the timing and cost-benefit considerations that drive the audit process, as well as the inherent limitations relating to the financial statement assertions and related available evidence. Furthermore, ISA 200 ought to include an explanation of the distinction between general categories of inherent limitations and specific inherent limitations and explain why a comprehensive list of specific inherent limitations cannot be developed. For those audit issues addressed in particular auditing standards for which specific inherent limitations are of particular importance (e.g., fraud, related parties, accounting estimates, going concern), the relevant ISA ought to include a short treatment of these specific inherent limitations.

21. The current exposure draft of ISA 200 includes significant improvements over current ISA 200. FEE notes the following matters that may be considered in a future revision of ISA 200:
    - Further delineation of sources and activities;
    - Reduction of the degree of overlap between the categories of sources of inherent limitations; and
    - Additional guidance on how the categories lead to different evidence concepts that explain the meaning of sufficient appropriate audit evidence.

1.6. The Relationship Between Inherent Limitations and Other Concepts

22. One of the major issues is the relationship between inherent limitations of an audit, absolute assurance and reasonable assurance (see paragraph 1). An examination of the relationship between inherent limitations of an audit, audit evidence, audit risk and reasonable assurance reveals that the inherent limitations of an audit have a direct impact upon the meaning of these concepts. It is the inherent limitations of an audit that determine what, and how much, evidence and hence the comfort (assurance) that can be obtained by the auditor and that an auditor considers necessary to obtain.

23. Auditing standards implicitly distinguish between obtainable audit evidence (the evidence, and hence assurance, an auditor can obtain) and the audit evidence, and hence assurance, that an auditor considers necessary to obtain, which are referred to as "sufficient appropriate audit evidence" and "reasonable assurance", respectively. Due to the inherent limitations (constraints) on the audit process arising from cost-benefit and timing considerations, the net benefit of obtaining additional audit evidence and hence assurance is subject to diminishing returns (the marginal benefit of obtaining additional evidence and hence assurance declines and, at some point, the marginal cost exceeds the marginal benefit). This means that auditors

should not and do not obtain all of the evidence and hence assurance obtainable. Diagrams in Sections 6.2.1 and 6.3.2 subsequent to paragraphs 220 and 248 of the Paper depict the relationship between different evidence and assurance concepts, respectively.

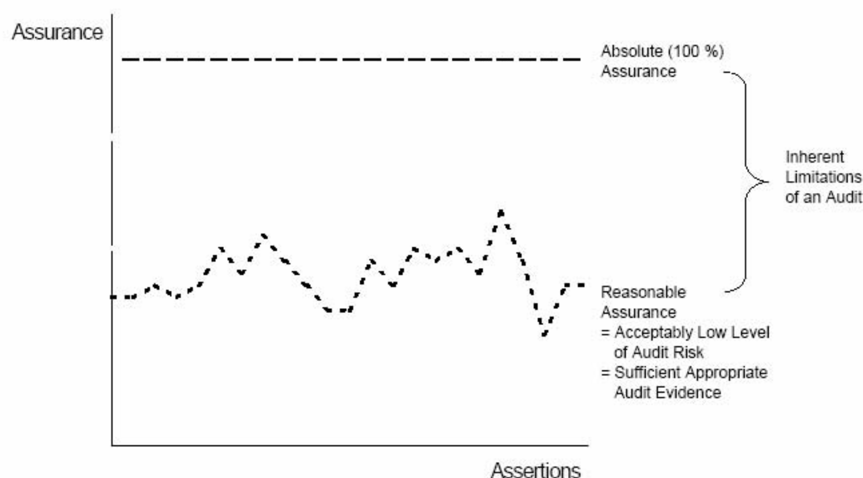
24. Auditors seek to mitigate the risk of material misstatement ("misstatement risk") in the financial statements by reducing detection risk. The inherent limitations of an audit imply not only that detection risk, and hence audit risk, cannot be reduced to zero, but also, that the desired level of detection risk, and hence the desired level of audit risk (an acceptably low level of risk), vary substantially by assertion. This is exacerbated by the fact that detection risk is not completely independent of the risk of material misstatement because, just as controls are often less effective in responding to certain inherent risks than others, so too, audit procedures performed to assess such risks and in response to assessed misstatement risks may also be less effective in assessing, or responding to, certain inherent and control risks than others.

25. Furthermore, to the extent that audit risks for particular financial statement assertions are independent of one another, the lowest level of audit risk that can be achieved for the financial statements as a whole cannot be less than that for the assertion with the greatest level of audit risk. Overall, these matters signify that there are inherent limitations on an auditor's ability to properly identify and assess risks of material misstatement. In addition, although auditors respond to all material risks of misstatement assessed as being greater than an acceptably low level, the effectiveness the responses available to, and hence performed by, an auditor, to address those assessed risks varies.

26. Likewise, then, given the inherent limitations of an audit and the variation in an acceptably low level of audit risk by assertion, not only can absolute (100 %) assurance not be achieved in an audit, but also what reasonable assurance is varies by financial statement assertion. Furthermore, to the extent that the levels of assurance obtained for different assertions are independent of one another, the highest level of assurance that can be achieved for the financial statements as a whole cannot be greater than that for which the least assurance was obtained. In other words, like financial statements, audits as a whole cannot be better than their weakest link.

27. Overall, this means that due to the inherent limitations of an audit beyond an auditor's control, it is not possible for auditors to perform additional audit procedures to identify and assess, and hence mitigate, misstatement risks to obtain a level of assurance that is always the same relative to absolute assurance. Furthermore, even if auditors were able to do so, it would not be desirable because in most circumstances the costs of performing additional procedures would exceed the benefits.

28. The following diagram represents a summary of the interrelationship between absolute assurance, inherent limitations of an audit, reasonable assurance, acceptably low level of audit risk, and sufficient appropriate audit evidence, by assertion. It does not contain the same level of detail as the diagrams subsequent to paragraphs 220 and 248 of the Paper. The diagram attempts to provide a simple illustration of the interrelationships between these concepts It is for illustrative purposes only, does not necessarily reflect all possible relationships among the concepts, and is not drawn to scale. Those seeking further explanation of the meaning of these interrelationships are referred to Sections 6.2.1 and 6.3.2.



29. The level of assurance that an auditor considers necessary (reasonable assurance) is less than the assurance that an auditor can obtain (obtainable assurance), which in turn is less than the assurance available if there were, for example, no limitations on auditor access to information (available assurance). For virtually all assertions in accrual financial statements, the assurance available must be less than absolute assurance because accrual financial statements always require estimations of the future outcomes of events (e.g., estimated remaining useful life of assets, or impairment of recoverable amounts below cost, the going concern assumption, etc.) and the outcome of future events always involves uncertainty that cannot be eliminated. Naturally, the greater the degree to which financial reporting frameworks include information based on future-oriented information, or information based on the prediction of future events (e.g. fair values of items for which no active market exists), the greater the difference between the available assurance and absolute assurance.

30. The fact that the reasonable assurance is context-driven, and hence may mean reasonable assurance reflects different levels of assurance relative to absolute among different assertions within a set of financial statements, and between different sets of financial statements, does not mean that audit work on different assertions within the financial statements, or audits of different financial statements, are inconsistent or not comparable. The expertise obtained by auditors through common forms of education and training enable experienced auditors to exercise reasonable judgement in determining when the costs of additional audit work may exceed the benefits in a broadly consistent manner in similar circumstances. However, this does not mean that the reasonable judgement of one auditor in this respect will always be the precisely same as that of another in any particular circumstance. It does mean that the relative costs vs. benefits of the reasonable assurance obtained would be roughly equivalent. For this reason, it is not a problem that audit reports remain the same in different situations.

31. It is important for auditing standards setters and the auditing profession to address unrealistic expectations in relation to audits that may be caused by readers interpreting auditing standards as suggesting that audits can achieve more than they actually can, such as users

interpreting the auditing standards as requiring the achievement of a uniform "high" level of assurance relative to absolute (100 %) assurance for every assertion in the financial statements and hence for the financial statements as a whole. Consequently, given the inherent limitations of an audit, it is important that the use of the term "high assurance" be appropriately qualified to convey the fact that "high" is being used as a relative term (i.e., high assurance in relation to obtainable assurance, as opposed to absolute assurance) by adding such words as "subject to the inherent limitations of an audit" to any use of the term "high assurance" (e.g., "reasonable assurance is a high level of assurance subject to the inherent limitations of an audit").

32. The concepts addressed in this Subsection, and in particular, the concept of reasonable assurance, are difficult for lay users of audit reports to understand. However, the fact that these concepts are difficult does not mean that there is a simpler conceptual replacement in sight that could solve this understandability problem. Rather, it appears to be important that these concepts be adequately explained in auditing standards.

1.7. Inherent Limitations, Expertise, Judgment and Standards

33. An important issue is the relationship between inherent limitations, reasonable assurance and professional judgment (including whether professional judgment is an inherent limitation) and how professional judgment is applied in relation to the objectives and requirements in auditing standards (see paragraph 1). The analysis in the Paper concludes that professional judgment represents a positive response by audit professionals to mitigate, in varying degrees, inherent limitations of an audit. Hence, professional judgment is itself not an inherent limitation.

34. Audits cannot be reduced to an algorithm because the application of accounting requirements and guidance to the transactions and other events, and circumstances or conditions, of an entity, the application of auditing standards and guidance, and hence the audit process, all require significant interpretation and therefore the application of significant professional judgment on the part of an auditor. Given the need for the application of professional judgment, and hence professional expertise, in professional activities, such as audits, professional auditing standards cannot represent a comprehensive list of procedures always necessary in all circumstances, but at most, a short list of procedures that are almost always necessary in most circumstances plus broad principles with application guidance for all of the other circumstances. A definitive, comprehensive list of procedures (an algorithm) would reduce the application of professional judgment for complex matters with a wide variation in circumstances and may lead to improper decision-making by professionals because they might not react to unforeseen risks.

35. Overall, the application of considerable professional judgment is involved in applying the ISAs in a particular audit. Professional judgment needs to be exercised within the parameters provided by the relevant objectives in the ISAs as defined in greater detail by the requirements and explained by the application material. The application of professional judgment needs to be justifiable and reasonable given the professional expertise of the auditor and the context in which the professional judgment is exercised. In exercising professional judgment, like other professionals, auditors are held to the standard of the "prudent practitioner" – that is, what other prudent practitioners would do in similar circumstances.

36. An auditor is required to document significant professional judgments made in reaching conclusions on significant matters arising during the audit. A matter is significant when an auditor's decisions about that matter at the time that matter is addressed in the course of the

audit has a greater than acceptably low level of risk of ultimately affecting the content of the auditor's report. The exercise of professional judgment is significant, and therefore should be documented, when the potential outcome of the exercise of that judgment has a greater than acceptably low level of risk of ultimately affecting an auditor's decisions on a significant matter at the time that judgment is made in the course of the audit. It may be advantageous to improve the treatment of documentation matters in ISA 230 by addressing this issue in the application material of that Standard.

37. It would be desirable that ISA 200 address professional judgment in greater detail than is currently the case and clarify that professional judgment is not an inherent limitation, but rather, a response by auditors to inherent limitations. As such, professional judgment enables auditors to apply their expertise so that the objective of an audit can be achieved in light of the requirements.

38. Professional judgment enables auditors to determine when the point has been reached at which the acquisition of additional assurance is no longer worth the benefit (which is related to the question as to whether sufficient appropriate audit evidence has been obtained). In these circumstances, auditors act on behalf of the other participants in the financial reporting supply chain in trying to balance the costs and benefits among them in the public interest. To this effect, professional judgment does not "reduce" the assurance that is regarded as reasonable: it defines it. Consequently, reasonable assurance cannot be obtained independently of the use of professional judgment.

1.8. The Enforceability of Auditing Standards that Require the Use of Professional Judgment

39. Another major issue is the enforceability of auditing standards (see paragraph 1), such as the ISAs, that require the use of professional judgment. In particular, concern has been expressed by Member States that professional judgment may constitute a "black box" not susceptible to effective enforcement.

40. The analysis in the Paper indicates that the ability of reviewers to scrutinise the professional judgment exercised by auditors in the performance of audits depends upon the expertise of those reviewers. Given that professional expertise is required to exercise professional judgment, it follows that essentially the same professional expertise is required of reviewers that scrutinise the exercise of that professional judgment. Such exercise of professional expertise by audit reviewers would also need to take place in same context as the exercise of professional judgment by the auditor – that is, in the context of the applicable auditing standards, accounting requirements and ethical standards, etc. Hence, reviewers with the appropriate expertise are able to scrutinise the reasonableness of significant professional judgment exercised by an auditor in the course of an audit. In particular, reviewers with the appropriate expertise are able to identify when the application of professional judgment in a particular instance may be clearly unreasonable.

41. Regardless of the system of enforcement in place (e.g., monitoring versus monitored peer review systems of quality assurance), reviewers ought to have, among other things, professional expertise in auditing, the application of auditing and accounting standards, professional ethics, etc. In particular, professional expertise in auditing signifies expertise in such matters as an understanding of materiality, financial statement assertions, risk assessment, responses to risk, the evaluation of audit evidence, the significance of matters to the audit report, and the exercise of professional judgment.

42. Consequently, the exercise of professional judgment by auditors is not a "black box" as long as those performing enforcement functions have, apart from the necessary information, the necessary expertise to scrutinise the reasonableness of the professional judgment exercised by auditors. This means that auditing standards that recognise the need for professional judgment and hence audits in which professional judgment is exercised are enforceable.

43. It may be useful for regulators and enforcement authorities to recognise that audit processes cannot be, and therefore are not, structured in accordance with the structure of auditing standards. Rather audit processes are largely driven, and hence structured, by the financial statement assertions that ought to be contained in the financial statements, for that is what auditors obtain evidence about to enable them to form an opinion about whether the financial statements are free of material misstatement, which, after all, is the objective of an audit. Consequently, attempts to design or use auditing standards as a "compliance checklist" for audit enforcement purposes will not be effective. Nevertheless, the content of auditing standards will influence the way in which regulators inspect audits. For this reason, enforcement of audits needs to be directed towards the audit process in light of the applicable auditing standards, rather than be driven solely by the structure of the auditing standards.

44. Enforceability of auditing standards is part of a broader issue of regulation and enforcement over auditing and the rest of the financial reporting supply chain. Regulation and effective enforcement over audits does not necessarily mitigate weaknesses in other parts of the financial reporting supply chain and is increasingly subject to diminishing returns. Therefore, consideration may need to be given to whether regulation and enforcement, in the public interest, of other parts of the financial reporting supply chain is adequate.

SECTION 2. INTRODUCTION

2.1. Purpose of the Paper

45. This Paper has been prepared by the Fédération des Experts Comptables Européens (FEE) – the European Federation of Accountants – the representative organisation of the accountancy profession in Europe, as a well-grounded technical response (albeit with political implications) to a request by the European Commission Services (DG MARKT) for more information on important issues with respect to audits including the inherent limitations of an audit and the relationship between inherent limitations of an audit and reasonable assurance (and its relationship to absolute assurance), professional judgment and its documentation, and the enforceability of auditing standards.
46. The identification of these issues by European Commission Services (DG MARKT) and its request of the profession to address these issues in this Paper do not constitute agreement or support by the European Commission for the contents of this Paper.
47. This Paper is also intended to provide thought leadership on audit issues in a European and global context. To this effect, the Paper also provides suggestions for the clarification of ISA 200.

2.2. The Approach Selected By FEE in this Paper to Address the Main Issues Identified

48. The revision of ISA 200 is the responsibility of the International Auditing and Assurance Standards Board (IAASB); such revision is currently being undertaken through the Clarity Project. Consequently, FEE proposes no fundamental amendment of the underlying principles underlying the currently issued or "closed-off" ISAs. Nevertheless, in helping to clarify the concepts addressed, in line with FEE's role in providing thought leadership on audit issues in Europe and globally, this Paper has developed further these concepts and an understanding of their interrelationships.
49. This Paper applies a technical – rather than political – approach to analyse the issues: the political implications of the reasoning and conclusions are beyond the scope of this Paper.
50. To enable an analysis of the issues in relation to level of assurance, professional judgment, objectives and requirements in the ISAs and inherent limitations of an audit, it is necessary to set the context for audits, for it is this context that engenders the inherent limitations of an audit. In particular, it is useful to examine the financial reporting process in which an audit is embedded as a process flow, which can be described as the information supply chain that delivers financial reporting to the market, or the "financial reporting supply chain". The Paper applies the concept of the financial reporting supply chain in its further analysis of the inherent limitations of an audit and develops a categorisation of inherent limitations based upon this perspective.
51. Furthermore, it is necessary to examine the interrelationship among the concepts. FEE's analysis in this Paper indicates that it is not possible to provide a "list" of specific inherent limitations of an audit: rather, the Paper examines the nature of the inherent limitations of an audit and attempts to categorise these limitations.
52. Although this Paper provides a theoretical treatment of some of the basic concepts underlying audits of financial statements, this Paper does not constitute a conceptual framework for audits. The development of such a conceptual framework would require

considerable additional research and stakeholder input and would cover additional fundamental conceptual issues beyond the scope of this Paper. In accordance with the main recommendations of the FEE Issues Paper "Principles of Assurance: Fundamental Theoretical Issues With Respect to Assurance in Assurance Engagements" published in April 2003, FEE continues to recommend that the accounting profession in Europe and worldwide and standards setters need to undertake to develop and agree a conceptual framework for assurance engagements that would serve as a foundation for future standards setting and guidance in this area and enhance discussions about auditing standards with stakeholders.

2.3. Scope of the Paper

53. The Paper begins with an overview of the nature of financial statements audits to set the context of such audits and introduces some relevant basic concepts of financial statements audits (Section 3) needed to understand the rest of the Paper. This Section introduces the "financial reporting supply chain", which represents the primary source of inherent limitations of an audit. Furthermore, the Section describes the premises upon which an audit is based as derived from agency theory and uses these to delineate the respective responsibilities of management and the auditors. Finally, this Section closes with a brief description of the ethical requirements that form the basis for auditing standards and hence the performance of audits.
54. The basic accounting and auditing concepts of financial statements assertions, materiality, material misstatements and risks of material misstatements have been treated in greater depth in a separate Section (Section 4). In particular, an understanding of misstatement risk is necessary to fully appreciate the meaning of inherent limitations of an audit, audit risk and reasonable assurance.
55. In Section 5, the Paper then addresses inherent limitations of an audit by first defining them and exploring their nature. The Paper explains why an exhaustive list of specific inherent limitations cannot be developed and therefore develops categorisations of general inherent limitations. The categorisation by source and control of inherent limitations is used as the primary basis for further description and discussion. Examples demonstrate how general inherent limitations of an audit manifest themselves as specific inherent limitations for particular audit issues. Section 5 provides recommendations on how the treatment of inherent limitations of an audit in the ISAs, and in particular, ISA 200, may be improved.
56. Section 6 explores the relationship between inherent limitations and other auditing concepts, including audit evidence, scope limitations, audit risk and reasonable assurance. In particular, this Section shows how the inherent limitations of an audit affect the meaning of such terms as sufficient appropriate audit evidence, acceptably low level of audit risk, and reasonable assurance.
57. In Section 7, the Paper covers the relationship between inherent limitations and professional expertise, judgment and professional standards, including auditing standards. As part of this analysis, the Section addresses the role of professional judgment in achieving the objective of an audit and meeting the requirements in the ISAs and how professional judgment is central to the definition of reasonable assurance in this context.
58. Section 8 examines the enforceability of auditing standards, such as the ISAs, that are built upon the exercise of professional judgment and addresses some of the prerequisites for such enforcement. Finally, in Section 9, the Paper briefly examines the benefits, costs and value-added of audits, and emphasises the value-added of audits despite the related inherent limitations of audits.

59. As requested by European Commission Services, potential consequences for the International Standards on Auditing (ISAs), and in particular, ISA 200, are addressed towards the end of each Section, when relevant.

SECTION 3. AN OVERVIEW OF THE NATURE OF FINANCIAL STATEMENT AUDITS

3.1. *Purpose of this Section*

60. The purpose of this Section is to provide an overview of the nature of financial statement audits to set the context in which financial statement audits take place. The Section:

    - Introduces a number of key terms needed to understand the rest of the Paper ("financial statements", "financial reporting framework", "financial reporting supply chain");
    - Describes the role of audits of financial statements and explains the role of agency theory as a foundation for that role: agency theory is important when delineating the respective responsibilities of management and the auditor;
    - Describes the role of the financial reporting supply chain, which represents the primary source of inherent limitations of an audit – especially those that are beyond the control of the auditor;
    - Describes the premises upon which an audit is based and hence management's responsibilities in relation to the financial statements;
    - Describes the basic responsibilities of a financial statement auditor, which also form the basis for some inherent limitations of an audit;
    - Introduces ethical requirements, which form the basis for auditing standards and hence the performance of audits, and the concept of professional scepticism, which both drives and limits auditor work effort.

3.2. *The Context of Financial Statement Audits*

3.2.1. *Financial Statements and Financial Reporting*

61. The objective of financial reporting is to provide valuable financial information about a reporting entity to users for decision-making and accountability purposes. There are different vehicles by which such financial reporting is undertaken, such as annual or interim reports to owners, creditors and other stakeholders, ad-hoc reports, prospective financial information and management reports or analyses made available to stakeholders.

62. However, the primary means by which such reporting is undertaken is ***historical financial information***, *which refers to information expressed in financial terms in relation to a particular entity, derived primarily from that entity's accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past*[1].

63. The historical financial information most commonly provided to users for decision-making and accountability purposes is in the form of ***historical financial statements*** *(hereinafter referred to as "**financial statements**") that are a structured representation of historical financial information, which ordinarily includes related explanatory notes, intended to*

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[1] International Federation of Accountants (IFAC), International Auditing and Assurance Standards Board (IAASB) Exposure Draft ISA 200 "Overall Objective of the Independent Auditor, and the Conduct of an Audit in Accordance with International Standards on Auditing", April 2007, paragraph 16 (f).

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 the financial reporting framework. The term "financial statements" ordinarily refers to a complete set of financial statements, but may also refer to a single financial statement[2].

64. *The term* ***"financial reporting framework"*** *refers to the criteria by which the financial statements are prepared, and may include financial reporting standards established by an authorised or recognised standards setting organisation, or legislative or regulatory requirements. In some cases the financial reporting framework may encompass both financial reporting standards established by an authorised or recognised standards setting organisation and legislative or regulatory requirements.* Other sources may provide direction on the application of the financial reporting framework. In some cases, the financial reporting framework may encompass such other sources or may even consist only of such sources[3].

65. The requirements of the applicable financial reporting framework determine the form and content of the financial statements[4]. For financial statements required to be prepared and filed by business corporations within the European Union, the Fourth and Seventh EU Directives, and the EU Regulations adopting International Financial Reporting Standards (IFRS), constitute the basis for the applicable financial reporting framework for unlisted business corporations and listed entities within the EU, respectively.

66. Financial reporting frameworks, such as IFRS, often have conceptual frameworks that address fundamental concepts underlying financial reporting. Such frameworks usually cover users and their information needs[5]. Issues addressed in those frameworks include:

    a) Financial statements need to be understandable to users[6];
    b) Benefits to users of financial statements should be worth the costs to users[7];
    c) Financial statements need be available on a timely basis[8]; and
    d) The concepts of the relevance, reliability and materiality (see Section 40 of this Paper) in relation to the financial statements[9].

67. These issues are therefore also relevant for audits. Financial reporting frameworks do not address the issue about the degree to which users can take comfort that the financial statements are in fact as relevant and reliable as they purport to be.

3.2.2. The Role of Audits of Financial Statements

68. The role of audits is generally justified with reference to agency theory. Agency theory operates under a number of assumptions, including:

    - For some legal forms of business enterprise, there is a separation of ownership (the principals: in this sense, the principals are users of financial information as noted in paragraph 66 above, and therefore the principals may include other stakeholders, such

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[2] IFAC, IAASB Exposure Draft ISA 200.16 (e), April 2007.
[3] IFAC, IAASB Exposure Draft ISA 200.A4, April 2007.
[4] IFAC, IAASB Exposure Draft ISA 200.A5, April 2007.
[5] International Accounting Standards Board (IASB), International Financial Reporting Standards (IFRSs) 2007, IAS Conceptual Framework, paragraphs 8 to 10 (IASCF.08-.10).
[6] IASB, IASCF.25, 2007.
[7] IASB, IASCF.44, 2007.
[8] IASB, IASCF.43, 2007.
[9] IASB, IASCF.26-.32, 2007.

as creditors) of the enterprise and management (the agents), who operate the enterprise on the owner's behalf;

- Both parties (principals and agents) are primarily interested in maximising their own wealth rather than that of the other party;
- The principal and agent have access to different information (information asymmetry); in particular, the agent has more information about the enterprise than the principal and therefore the agent is able to profit at the principal's expense;
- Since the principal does not have direct access to the enterprise, the principal will require some kind of monitoring mechanism (e.g., financial reporting by the agent) over the enterprise;
- Since the financial reports prepared by the agent may not have been prepared by someone acting in the principal's, rather than agent's interest, the principal will seek to "verify" those financial reports, since under the information hypothesis, "verified" information is more reliable than "unverified" information; and
- Unless the principal is an expert in accounting and auditing, the appointment of an independent external auditor acting for and on behalf of the principal (or on behalf of the principal's representatives, such as those charged with governance) would be more economically efficient and more effective than having the principal "verify" the financial reports[10].

69. Hence, an audit is seen as enhancing the degree of confidence or comfort that users have in the credibility of the financial statements: that is, that they are as relevant and reliable as they purport to be. For these reasons, audits are often required in some jurisdictions through law or regulation. For example, all mid-sized and large business corporations in the EU, as well as all listed entities, are required to have audits under the Fourth and Seventh EU Directives.

70. Overall, the role of audits depends largely upon users needs. However, this role is constrained by what an audit can and ought to deliver (deliverability): these constraints are often referred to as "inherent limitations of an audit", and are addressed in this Paper. These constraints primarily result from other parts of the financial reporting supply chain.

3.2.3. The Interdependence Between Audits and Other Parts of the Financial Reporting Supply Chain

71. Audits are not performed in isolation, but are a part of the environment in which they are performed. Consequently, the audit inputs, audit processes and outputs of audits, and the uses to which the outputs of audits are put, depend upon the other parts of the audit environment. In other words, as the IFAC Report "Rebuilding Confidence in Financial Reporting: An International Perspective" (hereinafter referred to as "the Report") issued by an independent IFAC Task Force pointed out, it may be useful to examine the financial reporting process as a process flow[11], which can be described as the information supply chain that delivers financial reporting to the market[12], or the "financial reporting supply chain". The other parts of the financial reporting supply chain impact the value (what an audit can deliver), including the quality, of audits, and are beyond the control of the auditor. Consequently, the financial reporting supply chain represents the primary source of inherent limitations of an audit –

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[10] Iain Gray and Stuart Manson, The Audit Process: Principles, Practice and Cases, Second Edition (Thomson Learning: London, 2000), pp. 9-10.

[11] International Federation of Accountants (IFAC), Independent IFAC Task Force on Rebuilding Confidence in Financial Reporting, Rebuilding Confidence in Financial Reporting: An International Perspective (IFAC: New York, 2003), pp. 7-8.

[12] IFAC, Independent IFAC Task Force on Rebuilding Confidence in Financial Reporting, 2003, p. 1.

especially those beyond the control of auditors.

72. The Appendix to this Paper includes a short informal treatment of examples of the matters affecting audit for which participants in the financial reporting supply chain other than auditors are responsible.

3.3. Some Relevant Basic Concepts and Premises Underlying Financial Statement Audits

3.3.1. Management Responsibility for the Financial Statements and to the Auditor

73. The performance of financial statements audits is based upon certain fundamental premises, that can be derived from agency theory, without which such an audit cannot be performed. These premises fundamental to an audit apply regardless of the legal responsibilities of management or those charged with governance in these respects.

74. These premises include that management, with the assistance of professional accountants within the entity (professional accountants in industry) and oversight from those charged with governance, is responsible for:

- The selection of the applicable financial reporting framework (which may be one prescribed by law or regulation);
- The selection of accounting policies in accordance with that framework; and
- The preparation and presentation of the financial statements in accordance with that framework.

75. These fundamental premises are management's responsibility. Were the auditor so responsible, ,the auditor would then no longer be performing an independent "verification" on behalf of the owners (the principals) of those financial statements: the auditor would be auditing his or her own work and therefore violate the independence requirements to which the auditor is subject.

76. A further premise underlying the performance of a financial statement audit is management's (or those charged with governance's) responsibility for the design, implementation and maintenance of adequate internal control relevant to the preparation and presentation of the financial statements in accordance with the applicable financial reporting framework – regardless of the legal responsibilities of management and those charged with governance in this respect. It is only management's design, implementation and maintenance of such adequate internal control that enables management to prepare and present the financial statements in accordance with the applicable financial reporting framework. Were the auditor to assume these responsibilities, the auditor would violate the independence requirements as noted in the previous paragraph.

77. An important fundamental premise underlying the performance of a financial statement audit is that it is management's responsibility to provide all of the information to the auditor needed by the auditor to perform the audit – regardless of the legal responsibilities of management or those charged with governance in this respect. This is because the documents, books, records and other information used to prepare and present the financial statements are under the control of management. Without this premise, a prudent auditor would then need to assume that not all information necessary for the performance of the audit has been provided, which would preclude the auditor from expressing an audit opinion.

78. The fundamental premises described above relate to what the responsibilities of management, with the assistance of professional accountants within the entity and the oversight of those charged with governance, are. However, the performance of a financial

statement audit is also predicated upon whether management and those charged with governance acknowledge and understand these responsibilities and the degree to which these responsibilities have been fulfilled.

3.3.2. Responsibilities of the Auditor

79. The responsibility of an auditor of financial statements is to express an opinion on whether the financial statements have been prepared and presented in accordance with the applicable financial reporting framework. To discharge this responsibility, through the audit the auditor obtains reasonable assurance about whether the financial statements as a whole are free of material misstatement and reports on the findings thereon resulting from the audit[13].

80. It should be emphasised that what the auditor expresses is a professional (expert) opinion on whether the financial statements as a whole have been prepared and presented in accordance with the applicable financial reporting framework – not an opinion on other matters. There may, of course, be other legal, regulatory, ethical or other professional requirements associated with an audit of the financial statements that may or may not require additional reporting by the auditor. However, any such additional reporting is separate from the opinion on whether the financial statements as a whole are prepared and presented in accordance with the applicable financial reporting framework.

3.3.3. Ethical Requirements for Auditors and Professional Scepticism

81. The IFAC Code of Ethics for Professional Accountants identifies the following "fundamental" principles with which professional accountants, and hence auditors, are required to comply:
    - Integrity,
    - Objectivity,
    - Professional Competence and Due Care,
    - Confidentiality, and
    - Professional Behaviour[14].

82. Three of the principles form the primary foundations of auditing standards: objectivity, which leads to the auditing requirement for professional scepticism in the conduct of the audit; professional competence, which forms the basis for the quality control requirements in relation to competence in International Standard on Quality Control (ISQC) 1 "Quality Control for Firms That Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services"[15] and ISA 220 "Quality Control for Audits of

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[13] Adapted from IFAC, IAASB Exposure Draft ISA 200 .04-.05, April 2007.

[14] International Federation of Accountants (IFAC) International Ethics Standards Board for Accountants (IESBA), Code of Ethics for Professional Accountants (effective June 30, 2006), from Handbook of International Auditing, Assurance, and Ethics Pronouncements, 2007 Edition (IFAC: New York, 2006), paragraph 100.4.

[15] International Federation of Accountants (IFAC), International Auditing and Assurance Standards Board (IAASB) International Standard on Quality Control (ISQC) 1 "Quality Control for Firms That Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services", from Handbook of International Auditing, Assurance, and Ethics Pronouncements, 2007 Edition (IFAC: New York, 2007), paragraph 36.

Historical Financial Information"[16]; and due care, which forms the basis for the operational auditing standards, which are an expression of the due care needed to perform the audit.

83. Professional scepticism represents a principle designed to buttress the objectivity of the auditor. In particular:

> "Professional scepticism is an attitude that involves the critical assessment, with a questioning mind, of the validity of audit evidence obtained. It includes recognising that circumstances may exist that cause the financial statements to be materially misstated, and being alert to audit evidence that contradicts or brings into question the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. Maintaining an attitude of professional scepticism throughout the audit is necessary if the auditor is, for example, to reduce the risks 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 audit procedures and evaluating the results thereof.
>
> Maintaining an attitude of professional scepticism is necessary to the critical assessment of audit evidence. However, an audit rarely involves the authentication of documents, nor is the auditor trained as or expected to be an expert in such authentication. Accordingly, unless the auditor has reason to believe the contrary (for example if conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been falsified) the auditor may accept records and documents as genuine"[17].

84. In relation to fraud, the auditor should recognise the possibility that fraud exists, notwithstanding the auditor's past experience with the entity about the honesty and integrity of management and those charged with governance[18]. However, the auditor cannot be expected to fully disregard past experience with the entity about the honesty and integrity of management and those charged with governance[19].

85. Professional scepticism both drives and limits auditor work effort: a 100% sceptical auditor would need to question the reliability and validity of every piece of information obtained through the audit; an auditor without any scepticism would accept everything that management represents as valid and reliable without performing any audit procedures. Consequently, the degree of scepticism that an auditor should have is an important factor in determining the nature of a financial statement audit and the meaning of "reasonable assurance"[20].

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[16] International Federation of Accountants (IFAC), International Auditing and Assurance Standards Board (IAASB) ISA 220 "Quality Control for Audits of Historical Financial Information", from Handbook of International Auditing, Assurance, and Ethics Pronouncements, 2007 Edition (IFAC: New York, 2007), paragraph 19.

[17] IFAC, IAASB Exposure Draft ISA 200.A26-.A27, April 2007.

[18] IFAC, IAASB ISA 240 (Redrafted) "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", 2007, paragraph 12.

[19] IFAC, IAASB ISA 240 (Redrafted) "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", 2007, paragraph A8.

[20] For a discussion of the meaning of professional scepticism, see the FEE Issues Paper "Principles of Assurance: Fundamental Theoretical Issues With Respect to Assurance in Assurance Engagements" (FEE: Brussels, April 2003), pp. 124-129; see also pp. 251-256 in relation to presumptions that practitioners may entertain in an assurance engagement, which is closely related to their required degree of scepticism.

3.3.4. Other relevant Basic Concepts Underlying a Financial Statement Audit

86. The basic concepts of materiality, material misstatements and the risks of material misstatements are central to the auditor's responsibility to audit the financial statements. These concepts are treated in greater depth in Section 4 of this Paper. Some other relevant basic concepts underlying a financial statement audit include the concepts of the inherent limitations of an audit, audit evidence, audit risk and reasonable assurance. These concepts are discussed in the following Sections of this Paper.

3.4. The Main Conclusions Drawn in this Section

87. The main conclusions drawn from the analyses in this Section include:
    - Important issues often addressed by financial reporting frameworks include materiality, that the benefits of providing such financial statements to users needs to be worth the costs to those users, and that the provision of such financial statements be on a timely basis: these issues are therefore also relevant to audits;
    - Agency theory operates under a number of assumptions that lead to the conclusion that where there is information asymmetry between users of financial statements and their preparers, it may be in user interests to have those financial statements audited by an independent auditor to increase the credibility of those financial statements: consequently audits are driven by user needs;
    - Nevertheless, audits are embedded in the financial reporting supply chain, which limits what an audit can deliver to users and therefore represents the primary source of inherent limitations of an audit;
    - Based upon agency theory, there are some premises upon which the performance of an audit is based, and in particular that:
        - Management is responsible for the preparation and presentation of the financial statements in accordance with the applicable financial reporting framework;
        - Management or those charged with governance are responsible for the design, implementation and maintenance of adequate internal control relevant to the preparation and presentation of the financial statements in accordance with the applicable financial reporting framework; and
        - Management is responsible for providing all of the information to the auditor needed by the auditor to perform the audit;
    - The responsibility of an auditor of financial statements is to express an opinion on whether the financial statements as a whole have been prepared and presented in accordance with the applicable financial reporting framework. To discharge this responsibility, through the audit the auditor obtains reasonable assurance about whether the financial statements as a whole are free of material misstatement and reports on the findings thereon resulting from the audit.

SECTION 4. ASSERTIONS, MATERIALITY, MATERIAL MISSTATEMENTS, AND RISKS OF MATERIAL MISSTATEMENT: MANAGEMENT AND AUDITOR PERSPECTIVES

4.1. Purpose of this Section

88. The purpose of this Section is to introduce and explain the concept of "risks of material misstatement" or "misstatement risk", which is the component of audit risk not under the direct control of the auditor. To adequately understand the meaning of audit risk and reasonable assurance, the work effort of auditors, and inherent limitations of an audit, it is necessary to have an understanding of misstatement risk. To explain the concept of "risks of material misstatement", it is necessary, from both a management and auditor perspective, to:
    - Explain the meaning of the terms "financial statement assertions" and "misstatement";
    - Explain the meaning and significance of the terms "materiality" and "tolerable error", which have an impact on the design and operation of internal control and on the performance of audits; and
    - Explain the nature and components of "risks of material misstatements", and in particular, inherent and control risks, which have an impact on audit risk and the meaning of inherent limitations of an audit, and hence reasonable assurance.

4.2. Assertions, Materiality, Material Misstatements, and Risks of Material Misstatement: Management Perspective

4.2.1. Financial Statement Assertions

89. The following analysis of financial statement assertions, materiality, material misstatements and the risks of material misstatement from a management perspective addresses concepts that de facto managements apply, or ought to apply, in preparing and presenting their financial statements in order for them to satisfy their responsibilities as defined by the premises of an audit (see Section 3.3.1). However, it should be recognised that most managements do not commonly think of their preparation and presentation of the financial statements in these terms.

90. The preparation and presentation of the financial statements involves the application of the requirements and guidance in the applicable financial reporting framework to the "transactions and other events, and circumstances or conditions, of the entity" , hereinafter generally shortened to refer to "the circumstances of the entity". In particular, the application of the framework involves applying the recognition, measurement, classification, presentation and disclosure requirements and guidance in that framework to the circumstances of the entity.

91. *The interaction between these requirements and guidance of a financial reporting framework, and the circumstances of the entity, results in what are called the "**required financial statement assertions**" for those financial statements – that is, what the required content of those financial statements ought to be, both for the financial statements as a whole (e.g., the going concern assertion) or for particular amounts and disclosures in the financial statements (the recognition, measurement, classification and disclosure assertions in relation to particular financial statement items).* In other words, financial statement assertions are "entity and framework driven".

92. As noted in Section 3.3.1, the preparation and presentation of the financial statements in accordance with the applicable financial reporting framework are the responsibility of management. Consequently, the contents of the financial statements as prepared and presented by management constitute representations by management about the application of the requirements and guidance of the applicable financial reporting framework to the circumstances of the entity – i.e., about the financial statement assertions. However, there are cases where the financial statement assertions presented in management's financial statements do not reflect the required financial statement assertions (i.e., the financial statements are "misstated").

4.2.2. Misstatements

93. *A **misstatement** of the financial statements is the difference between an amount, classification, presentation, or disclosure of a reported financial statement item (a financial statement assertion), and the amount, classification, presentation or disclosure that is required for that item to be in accordance with the applicable financial reporting framework*[21] *(the required financial statement assertion).*

94. In some circumstances, whether a particular accounting treatment would lead to a misstatement may involve little doubt (called "factual misstatements")[22]. In other circumstances judgment may be involved because the application of the recognition, measurement, classification, presentation and disclosure requirements of a financial reporting framework may require considerable interpretation on the part of management or the circumstances to which these requirements are being applied are unclear. Misstatements resulting from such accounting treatments are called "judgmental misstatements"[23], although the dividing line between judgmental and factual misstatements is in itself a matter of judgment.

4.2.3. Materiality and Material Misstatements

95. *Financial reporting frameworks generally do not require, or allow for, complete precision in the preparation and presentation of the financial statements – that is, the financial statements are not required to be prepared and presented free of all misstatements – because most financial reporting frameworks recognise the principle of **materiality***. Consequently, management does not have a responsibility to prepare and present such financial statements such that they are free of all misstatements, but rather, that they are free of *material* misstatements.

96. Together with the nature of the transactions and other events, and circumstances or conditions of the entity, the concept of *materiality* drives the precision with which amounts in financial statements are prepared and presented, whether amounts are prepared and presented, and the nature and extent of qualitative disclosures in those financial statements. Materiality is an accounting concept – that is, it applies to the preparation and presentation of the financial statements independent of whether an audit is performed on those financial

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[21] International Federation of Accountants (IFAC), International Auditing and Assurance Standards Board (IAASB) Exposure Draft "Proposed Redrafted International Standard on Auditing ISA 450, Evaluation of Misstatements Identified During the Audit" (IFAC: New York, October 2006), paragraph 4 (d).

[22] IFAC, IAASB Exposure Draft Proposed Redrafted ISA 450.04(b), October 2006.

[23] IFAC, IAASB Exposure Draft Proposed Redrafted ISA 450.04(c), October 2006.

statements[24].

97. Generally, financial reporting frameworks apply a user-driven concept of materiality. In particular, in such frameworks, misstatements are considered to be material if they, individually or in aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. Furthermore, unless the financial statements involved are special-purpose financial statements[25], judgments about misstatements that are material to users of financial statements are based on a consideration of the common financial information needs of users as a group; the possible effect of matters on specific individual users, whose needs may vary widely, is not considered[26].

98. The concept of materiality is based upon the assumptions that users:

- Have reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;
- Understand that financial statements are prepared and presented using materiality thresholds;
- Recognise the uncertainties and imprecision based upon judgments inherent in the recognition, measurement, classification and presentation of amounts and disclosures in the preparation and presentation of the financial statements; and
- Make reasonable economic decisions on the basis of the information in the financial statements[27].

99. Judgments about materiality are made in light of the surrounding circumstances, and are affected by the size or nature of the misstatement, or a combination of both[28], but are not affected by uncertainties about recognition, classification, presentation or disclosure, or about imprecision in measurement. Financial reporting frameworks recognise the judgmental nature of the determination of materiality and recognise that materiality is both a quantitative and qualitative concept[29]. Consequently, they generally do not provide any specific guidance for quantitative thresholds of materiality. Furthermore, qualitative materiality cannot be subjected to any such quantitative guidance. For these reasons, the determination of materiality by preparers, whether quantitative or qualitative, remains a matter of judgment.

100. The concept of materiality distinguishes not only between its quantitative and qualitative aspects, but also between a materiality level for the financial statements as a whole as opposed to materiality levels for particular classes of transactions, account balances or disclosures[30]. When management or those charged with governance assert that the financial statements are prepared and presented in accordance with the financial reporting framework – especially when management asserts that the financial statements give a true and fair view or present fairly, in all material respects, in accordance with the framework – such an assertion applies to the financial statements as a whole, rather than to particular items in the

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24 Financial reporting frameworks often discuss the concept of materiality: see International Federation of Accountants (IFAC), International Auditing and Assurance Standards Board (IAASB) Exposure Draft "Proposed Redrafted International Standard on Auditing ISA 320 (Revised), Materiality in Planning and Performing the Audit" (IFAC: New York, October 2006), paragraph 2.

25 International Federation of Accountants (IFAC), International Auditing and Assurance Standards Board (IAASB) Exposure Draft ISA 800 (Revised) "Special Considerations – Audits of Special Purpose Financial Statements and Specific Elements, Accounts or Items of a Financial Statement", (IFAC: New York, July 2007), paragraphs 9(b) and A9-A10.

26 IFAC, IAASB Exposure Draft Proposed Redrafted ISA 320.02, October 2006.

27 IFAC, IAASB Exposure Draft Proposed Redrafted ISA 320.04, October 2006.

28 IFAC, IAASB Exposure Draft Proposed Redrafted ISA 320.02, October 2006.

29 For example, see IASB, IAS 8.05, definition of materiality, 2007.

30 IFAC, IAASB Exposure Draft Proposed Redrafted ISA 320.09-.10, October 2006.

financial statements, whether amounts or qualitative disclosures. It should be noted that an assertion as to whether the financial statements give a true and fair view or present fairly, in all material respects, in accordance with the framework is consequently – in the first instance – an accounting, not an auditing, issue. It represents an additional assertion by management in relation to the financial statements as a whole beyond the other specific accounting requirements.

101. This means that, generally, the materiality of misstatements of particular amounts or qualitative disclosures is seen in the context of the financial statements as a whole, rather than in the context of the individual financial statement items, whether amounts or qualitative disclosures. This implies that, in preparing and presenting the financial statements, quantitative considerations of materiality lead to the determination of one level of quantitative materiality for the financial statements as a whole[31] and the materiality of misstatements of particular qualitative disclosures is determined by reference to the financial statements as a whole, rather than the determination of a separate materiality level for each amount and qualitative disclosure in isolation.

102. Nevertheless, there are qualitative aspects of materiality affecting the quantitative materiality level for particular classes of transactions, account balances and disclosures (i.e., in other words, management needs to consider not only the size, but also the nature of particular amounts and disclosures)[32]. For this reason, when preparing and presenting the financial statements, management needs to consider whether, in the specific circumstances of the entity, there are particular classes of transactions, account balances or disclosures for which quantitative and qualitative thresholds of materiality less than the materiality level for the financial statements as a whole would be material[33]. The determination of materiality for the financial statements as a whole, the consideration of the qualitative aspects of materiality, and the determination of materiality level for particular classes of transactions, account balances and disclosures involve the use of judgment.

4.2.4. Management's Tolerable Error

103. When engaging in risk management over both operations and the preparation and presentation of the financial statements, management assesses the likelihood and impact of risks as a basis for determining how these risks should be managed. Based upon this risk assessment, management then selects responses to the assessed risks, which may include their avoidance, assumption, reduction, or sharing. The establishment of internal control is a response to the risks assessed by management[34]. Hence, as a matter of risk management theory (as opposed to audit theory) management assesses the risks relevant to the preparation and presentation of the financial statements and designs, implements and maintains internal control to respond to those assessed risks. In this sense, internal control represents *a* response (note the other possible responses in the second sentence above) to mitigate inherent risks.

104. All other things being equal, the lower the level of materiality for management, the greater the risks relevant to the preparation and presentation of the financial statements would be and hence the more stringent the design, implementation and maintenance of internal control relevant to the preparation and presentation of the financial statements would be. However, in assessing the risks relevant to the preparation and presentation of the financial statements

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31 Adapted from IFAC, IAASB Exposure Draft Proposed Redrafted ISA 320.09, October 2006.

32 Adapted from IFAC, IAASB Exposure Draft Proposed Redrafted ISA 320.06, October 2006.

33 Adapted from IFAC, IAASB Exposure Draft Proposed Redrafted ISA 320.10, October 2006.

34 Adapted from The Committee of Sponsoring Organizations of the Treadway Commission (COSO), Enterprise Risk Management – Integrated Framework (COSO/AICPA: New Jersey, USA, 2004), p. 6.

and designing, implementing and maintaining internal control to respond to those assessed risks, management needs to take into account the risks that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated.

105. Hence, management would need to determine an amount or amounts lower than the materiality level of the financial statements as a whole (and an amount or amounts lower than the materiality level for particular classes of transactions, accounts balances or disclosures, if applicable) for the purposes of such a risk assessment and designing, implementing and maintaining such internal control. For the purposes of this Paper, we will call this amount or amounts lower than the materiality level "tolerable error". Tolerable error from management's perspective drives the precision with which, and hence the extent (depth) to which, management's risk assessment is performed and the precision with which internal control is designed to prevent, or detect and correct, misstatements.

106. Since internal control also involves other management objectives, such as safeguarding of assets, tolerable error for internal control purposes may actually be set at a lower level than is needed for the preparation and presentation of the financial statements. Consequently, the processing of transactions (e.g., controls over cash), which involves the acquisition and disposal of assets, generally involves internal controls of greater stringency over the precision of amounts (e.g., in some circumstances, due to risk of fraud, reconciliation of cash balances in bank accounts may need to be accurate to otherwise trivial amounts) than controls over accounting accruals (e.g., calculation of prepaid expenses or accounting estimates, where such precision is not desirable or achievable) that involve the allocation of income and expenditures over time.

107. Needless to say, much like the determination of materiality, the determination of tolerable error involves the application of judgment. Furthermore, management's assessment of the risks relevant to the preparation and presentation of the financial statements and management's design, implementation and maintenance of internal control to respond to those assessed risks also involve the application of judgment on the part of management[35].

4.2.5. Risks of Material Misstatement

108. *The* ***risks of material misstatement*** *relate to the likelihood of occurrence of a material misstatement in the financial statements prior to their audit.* Such *misstatement risks* in the financial statements prepared and presented by management exist at both a financial statement level, and at an assertion level for classes of transactions, account balances and disclosures[36]. Because assertions for specific financial statement items within the financial statements relate to the specific recognition, measurement, classification, presentation and disclosure requirements of the financial reporting framework for specific financial statement items, the nature of the financial statement assertions and their associated risks of misstatement at an assertion level are "entity and framework driven".

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[35] Both the SEC's Commission Statement on Implementation of Internal Control Requirements (U.S. SEC 2005-74) and the SEC's Staff Statement on Management's Report on Internal Control Over Financial Reporting from May 16, 2005 recognise that management's assessment of internal control over financial reporting requires judgment; if such an assessment requires judgment on the part of management, then so must management's assessment of risks relevant to the preparation and presentation of the financial statements and the design, implementation and maintenance of controls to respond to those risks.

[36] IFAC, IAASB ISA 315 (Redrafted), "Identifying And Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", 2007, paragraph 24.

109. However, there are risks of material misstatement that relate more pervasively to the financial statements as a whole by potentially affecting many assertions in many unrelated financial statement items. These, for example, may be inherent (e.g., may arise from the nature of the business) or relate to internal control (e.g., may arise from the effect of weaknesses in the control environment).

110. *The* ***risks of material misstatement*** *at both the financial statement and assertion levels consist of two components: inherent risk and control risk.* Inherent risks at the financial statement level may arise from:

- The industry, regulatory and other external factors in which the entity operates;
- The nature of the entity, including the nature of its operations, ownership and governance structure, the types of investments that the entity is making and plans to make, the structure of the entity and how the entity is financed;
- The objectives and strategies of the entity and related business risks; and
- The means by which the entity measures and reviews performance[37].

111. Control risks at the financial statement level may arise from weak control environments, entity business risk assessment processes, information systems and related business processes, and monitoring of controls[38].

112. Inherent risk at the assertion level refers to the susceptibility of an assertion to a material misstatement, either individually or when aggregated with other misstatements, assuming that there are no related controls: it is driven entirely by the interaction between the requirements of the financial reporting framework and the circumstances of the entity. This risk is greater for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, inherent risks in relation to cash, which is susceptible to theft, are greater than those in relation to the theft of real property in jurisdictions with incontestable property registries.

113. Control risk at the assertion level refers to the susceptibility of an assertion to a material misstatement, either individually or when aggregated with other misstatements, because the material misstatement will not be prevented, or detected and corrected, on a timely basis by the entity's internal control. This risk is a function of the effectiveness of the design and operation of internal control relevant to the preparation and presentation of the financial statements[39]. Controls are more effective in responding to some kinds of inherent risks than others. For example, internal controls designed to prevent, or detect and correct, errors in routine computations are generally more effective than internal controls are against fraud risks, which may be subject to management override.

114. By definition, there are always inherent risks at the financial statement level, and control risks at the financial statement level can never be completely eliminated because there is no such thing as perfect control environments, business risk assessment processes, etc. – particularly given the ability of management to override internal control (note the connection to agency theory). Consequently, inherent and control risk, can never, whether individually or collectively, be reduced to zero. Furthermore, because inherent risks are greater for some assertions and related classes of transactions, account balances, and disclosures than for others, and because controls are more effective in responding to some kinds of inherent risks than others, the risks of material misstatement vary greatly among the assertions. This is exacerbated by the fact that inherent and control risks, at both the financial statement level and for specific assertions, are not completely independent of one another: often assertions

[37] Adapted from IFAC, IAASB ISA 315.11, 2007.
[38] Adapted from IFAC, IAASB ISA 315.A38-.A99, 2007.
[39] Adapted from IFAC, IAASB Exposure Draft ISA 200.A16, April 2007.

with high inherent risks are those that are less susceptible to risk management through control.

115. Since inherent and control risks, and hence misstatement risk, relate to the *likelihood of occurrence* of a material misstatement in the financial statements prior to their audit, there is a probabilistic relationship between these that is often expressed in Bayesian terms to aid theoretical understanding (and prevent additive application of risks in practice – not to provide a precise numerical analysis of risk) as follows: misstatement risk = inherent risk x control risk. However, this formula applies only if inherent and control risk are completely independent of one another, which, as noted above, is often not the case. This greatly complicates the mathematics involved. Furthermore, an actual, objective determination of numerical values for these is not possible in practice: this implies the need for the application of judgment.

116. To the extent that risks of material misstatement for particular assertions in the financial statements are independent of one another, the risk of material misstatement for the financial statements as a whole cannot be less than the risk of material misstatement for the assertion with the greatest such risk (i.e., the financial statements as a whole cannot be better than their weakest link). There are, in other words, *inherent limitations* on the ability of internal control to respond to inherent risks to reduce the risk of material misstatement for the financial statements as a whole. Consequently, the risk of material misstatement in financial statements as a whole may remain substantial (that is, at a level greater than is often acceptable to external stakeholders of the entity).

4.2.6. Some General Implications of the Risks of Material Misstatement for Audits

117. The fact that the risk of material misstatement may remain substantial given the assumptions of agency theory and the inherent limitations of internal control is the reason why audits of financials statements are considered desirable by external stakeholders, are often required by statute for certain kinds of business entities (e.g., the Fourth and Seventh EU Directives) and are performed: to detect material misstatements that the entity has not prevented, or detected and corrected, by means of its internal control. However, it should be emphasised that misstatement risk (inherent and control risk, at both the financial statement and assertion levels) is an inherent limitation of the financial statements that is beyond the control of the auditor. An audit is directed at mitigating this risk and therefore auditors assess this risk and then respond to it through the audit to mitigate that risk, but cannot reduce this risk. By mitigating misstatement risk through the audit, the auditor reduces the risk to users that material misstatements exist in the (audited) financial statements.

118. Nevertheless, the prospect of an audit may influence inherent and control risk indirectly. For example, the fact that an audit will be performed may deter those with an opportunity and motive to commit fraud from doing so; in any case, a prospective audit raises the hurdle for a successful material fraud because the audit would make it necessary for the potential perpetrator to engage in sophisticated concealment activities and to collude with others, which makes fraud a much more difficult proposition. Furthermore, a prospective audit may cause management to seek to remedy weaknesses in internal control over financial reporting prior to the commencement of the audit to reduce necessary audit work effort and hence audit fees, as well as causing those involved in the accounting function to be more diligent in their work. On the other hand, there is the moral hazard that management and others involved in the accounting function may cease to be as diligent because of the expectation that the auditor would detect material misstatements through the audit.

4.3. *Assertions, Materiality, Material Misstatements, and Risks of Material Misstatement: Auditor Perspective*

4.3.1. *Financial Statement Assertions*

119. As noted in paragraph 79, through the audit the auditor obtains reasonable assurance about whether the financial statements as a whole are free of material misstatement. Audits are directed towards, and are hence planned and performed, to examine whether the financial statements contain the required assertions. Consequently, like the preparation and presentation of the financial statements (see paragraph 91), audits are financial statement assertion, and hence entity and framework, driven.

4.3.2. *Materiality and Material Misstatements*

120. As noted in paragraph 95, because of their recognition of the concept of *materiality*, most financial reporting frameworks do not require, or allow for, complete precision in the preparation and presentation of the financial statements. This constitutes an inherent limitation of the financial statements and hence of an audit because the audits of those financial statements cannot be performed with greater precision than that required of the financial statements. Consequently, audits are directed towards the detection of *material*, rather than all, misstatements. This implies that the concept of materiality drives the precision with which financial statements are audited. Hence, although materiality is an accounting concept as described in paragraph 96, the concept of materiality is central to the performance of an audit.

121. Since materiality is an accounting concept, materiality for audit purposes should not be different from that for the preparation and presentation of the financial statements. Hence, like the determination of materiality for the preparation and presentation of the financial statements by management, the determination of materiality by the auditor for audit purposes is also user-driven (see paragraph 97), made in light of the surrounding circumstances, affected by the size or nature of the misstatement, or a combination of both[40], (but is not affected by uncertainties about recognition, classification, presentation or disclosure, or about imprecision in measurement), and judgmental in nature (see paragraph 99).

122. Since accounting standards setters for general purpose financial statements have refrained from defining quantitative materiality thresholds for financial statements due to the judgmental nature of materiality (see paragraph 99), it would be inappropriate for auditing standards setters to do so, for they would then be exceeding their authority by encroaching upon standards for financial reporting. Consequently, the determination of materiality (both quantitative and qualitative) involves the exercise of professional judgment on the part of the auditor[41].

123. In alignment with the fact that management's assertion that the preparation and presentation of the financial statements is in accordance with the financial reporting framework relates to the financial statements *as a whole* (see paragraphs 100 and 101), the auditor's opinion is on the financial statements *as a whole* and not on individual financial statement items (this is particularly the case for the accounting assertion as to whether the financial statements give a true and fair view, or fairly present, in all material respects). Consequently, like management, auditors generally determine one level of quantitative materiality for the financial statements

[40] Adapted from IFAC, IAASB Exposure Draft Proposed Redrafted ISA 320.02-.04, October 2006.
[41] Adapted from IFAC, IAASB Exposure Draft Proposed Redrafted ISA 320.A4, October 2006.

as a whole[42] and the materiality of misstatements of particular qualitative disclosures is determined by reference to the financial statements as a whole, rather than the determination of a separate materiality level of each amount and qualitative disclosure in isolation (see paragraph 101). Such a determination of materiality for the financial statements as a whole requires the exercise of professional judgment on the part of the auditor[43].

124. Nevertheless, as described in paragraph 102, like management, auditors need to consider whether, in the specific circumstances of the entity, there are particular classes of transactions, account balances or disclosures for which quantitative and qualitative thresholds less than the materiality level for the financial statements as a whole would be material[44], which also involves the application of professional judgment by the auditor. As a result, the concept of materiality drives the definition of a material misstatement for the financial statements as a whole, and for particular classes of transactions, account balances and disclosures, if applicable, and hence the potential content of the auditor's opinion.

4.3.3. Assessing the Risk of Material Misstatement, and Auditors' Tolerable Error

125. The application of a risk-based audit approach by the auditor implies that the auditor assesses the risks of material misstatement arising from inherent and control risks at both financial statement and assertion levels and designs further audit procedures to respond to those assessed risks. For the reasons noted in paragraph 115, with the exception of the identification and assessment of significant risks, the ISAs do not require a separate identification and assessment of inherent and control risk, but direct the auditor towards a combined risk assessment (this does not preclude the auditor from first assessing inherent and control risks separately). Since the audit is directed towards the detection of material misstatements of assertions in the financial statements, the nature and extent of the audit process is very much driven by the assertions required in the financial statements (or the accounting or business processes that give rise to these) and the misstatement risks assessed by the auditor in relation to those assertions. All other things being equal, the lower the level of audit materiality, the greater the assessed risks of material misstatement: hence the level or levels of materiality affect the auditor's assessment of risks of material misstatement; such an assessment of misstatement risks (whether inherent and control risks separately or in a combined assessment) involves professional judgment on the part of the auditor.

126. Nevertheless, in assessing the risks of material misstatement and designing further audit procedures to respond to those assessed risks, the auditor needs to take into account that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and that detected misstatements may be indicative that there are further undetected misstatements in the financial statements[45]. Hence, based on the level of materiality and the auditor's expectations about the nature and extent of misstatements in the financial statements, the auditor needs to determine an amount or amounts lower than the materiality level for the financial statements as a whole (and an amount or amounts lower than the materiality level for particular classes of transactions, account balances, or disclosures, if applicable) for the purposes of assessing the risks of material misstatements and designing and performing further audit procedures[46].

[42] IFAC, IAASB Exposure Draft Proposed Redrafted ISA 320.09, October 2006.
[43] IFAC, IAASB Exposure Draft Proposed Redrafted ISA 320.A4, October 2006.
[44] IFAC, IAASB Exposure Draft Proposed Redrafted ISA 320.10 and .A11-.A12, October 2006.
[45] IFAC, IAASB Exposure Draft Proposed Redrafted ISA 320.A13, October 2006.
[46] IFAC, IAASB Exposure Draft Proposed Redrafted ISA 320.11, October 2006.

127. For the purposes of this Paper, this amount or amounts lower than the auditor's materiality level will be called the "auditor's tolerable error", the determination of which requires the application of professional judgment by the auditor. Although an auditor sets tolerable error independently of management's tolerable error (see paragraphs 103 to 106), when management's tolerable error exceeds that of the auditor, the audit may be subject to a scope limitation with respect to certain assertions, since an audit cannot be performed to greater level of precision than the precision to which the entity's internal control system operates for some assertions (this is of particular relevance for the "completeness" assertion). Generally, the auditor's tolerable error would be significantly greater than that of management's (which may be set for objectives other than the preparation and presentation of the financial statements – see paragraph 106), but significantly less than materiality.

128. The level of the auditor's tolerable error drives the precision with which, and hence the extent (depth) to which, the auditor's assessment of the risk of misstatements is performed. The lower the level of materiality and the greater the auditor's expectations about the nature and extent of misstatements in the financial statements, the lower the auditor would set the level of the auditor's tolerable error. Consequently, the level of materiality and the auditor's expectations about the nature and extent of misstatements in the financial statements drive the precision with which, and hence the extent (depth) to which the auditor's assessment of the risk of misstatements is performed. Based upon the results of the auditor's assessment of the risks of misstatement, the auditor may need to revise the level of the auditor's tolerable error. Greater assessed risks of material misstatement would lead to a determination of a revision of auditor's tolerable error downwards in relation to materiality and hence to a greater extent of further audit procedures in response to the assessed risks of misstatement.

129. Lower levels of auditors' tolerable error lead to greater work effort in the audit. Consequently, the level of materiality and hence the auditor's tolerable error have a significant influence on the work effort in an audit. If tolerable error is set too high in relation to materiality, insufficient audit testing may result in a greater likelihood that misstatements may not be detected, but detected misstatements are more likely to cause projected *material* misstatements. Hence, unless misstatements are detected despite the lower likelihood of their detection, the auditor may not have performed enough audit work to reduce audit risk to an acceptably low level (see the treatment of audit risk in Section 6.3.1). On the other hand, if tolerable error is set too low in relation to materiality, misstatements are more likely to be detected, but detected misstatements are less likely to cause projected *material* misstatements. In this circumstance, the auditor may perform too much work in relation to the risks of material misstatement and hence the audit may be economically inefficient.

4.4. The Main Conclusions Drawn in this Section

130. The main conclusions drawn from the analyses in this Section include:

- Inherent risk is greater for some assertions and related classes of transactions, account balances, and disclosures than for others. Controls are more effective in responding to some kinds of inherent risks than others;
- Inherent and control risk, can never, whether individually or collectively, be reduced to zero. Furthermore, because inherent risks are greater for some assertions and related classes of transactions, account balances, and disclosures than for others, and because controls are more effective in responding to some kinds of inherent risks than others, the risks of material misstatement vary greatly among the assertions. This is exacerbated by the fact that inherent and control risks, at both the financial statement level and for specific assertions, are often not completely independent of one another: often assertions with high inherent risks are those that are less susceptible to risk management through control;
- Since inherent and control risks, and hence misstatement risk, relate to the *likelihood of occurrence* of a material misstatement in the financial statements prior to their audit, to aid theoretical understanding there is a probabilistic relationship between these that is often expressed as follows: misstatement risk = inherent risk x control risk. However, this formula applies only if inherent and control risk are completely independent of one another, which, as noted above, is often not the case. This greatly complicates the mathematics involved. Furthermore, an actual, objective determination of numerical values for these is not possible in practice: this implies the need for the application of judgment;
- The assertion as to whether the financial statements give a true and fair view, or present fairly, in all material respects is – in the first instance – an accounting, not an auditing issue. It represents an additional assertion by management in relation to the financial statements as a whole beyond other specific accounting requirements. As financial statement assertion, it is, however, also subject to audit when the financial statements are audited;
- To the extent that risks of material misstatement for particular assertions in the financial statements are independent of one another, the risk of material misstatement for the financial statements as a whole cannot be less than the risk of material misstatement for the assertion with the greatest such risk (i.e., the financial statements as a whole cannot be better than their weakest link). There are, in other words, *inherent limitations* on the ability of internal control to respond to inherent risks to reduce the risk of material misstatement for the financial statements as a whole;
- Misstatement risk (inherent and control risk, at both the financial statement and assertion levels) is an inherent limitation of the financial statements that *is beyond the control of the auditor*. The audit is directed at mitigating this risk and so auditors assess this risk and then respond to it to mitigate this risk. By mitigating misstatement risk through the audit, the auditor reduces the risk to users that material misstatements exist in the (audited) financial statements; and
- Since the audit is directed towards the detection of material misstatements of assertions in the financial statements as required by the financial reporting framework, the nature and extent of the audit process is very much driven by the assertions in the financial statements required by the financial reporting framework and the misstatement risks assessed by the auditor in relation to those assertions.

SECTION 5. INHERENT LIMITATIONS OF AN AUDIT

5.1. Purpose of this Section

131. The purpose of the Section is:
- To describe the nature of inherent limitations of an audit;
- To explain why an exhaustive list of specific inherent limitations of an audit cannot be developed;
- To develop useful categorisations of general inherent limitations of an audit;
- To explain the nature of the categories, primarily by means of examples;
- To examine more closely the sources of such inherent limitations and the degree of control that auditors can exercise over these inherent limitations;
- To demonstrate by means of examples how general inherent limitations manifest themselves for particular audit issues as specific inherent limitations (for those audit issues for which inherent limitations are particularly important); and
- To examine the current treatment of inherent limitations in the ISAs and provide recommendations for improvement.

5.2. Description of Inherent Limitations of an Audit

132. It is in the nature of any human activity that it is subject to limits: this applies to audits too. Nevertheless, it is also a fact of human nature that those benefiting from an activity will seek to maximise their net benefit from that activity. Users of financial statements clearly seek to maximise their net benefits from their use of those financial statements: this also applies to their use of an auditor's report in connection with their use of those financial statements. The goal of maximising the net benefits means that users of auditors' reports would seek to:
- Reduce the costs, relative to the benefits, associated with audits as much as possible;
- Obtain those reports as soon as possible because financial information loses relevance over time (i.e., it becomes less decision-useful);
- Extend the coverage (i.e., what auditors' reports are responsible for in relation to an entity whose financial statements are being audited) as much as possible to maximise their benefits from those auditors' reports and then seek to use audits for these wider purposes; and
- Maximise the assurance that audits convey to them so that this assurance would come as close as possible to constituting a guarantee (absolute assurance).

In short, in an ideal world, users of audits would desire from auditors a guarantee for everything associated with the entity right away at no cost.

133. Needless to say, what users may like to have in an ideal world falls short of what can be delivered (i.e. what is deliverable) in the real world due to the *inherent limitations of an audit*. In a sense, the inherent limitations of an audit translate into limitations on the value of an audit for users. Nevertheless, audits provide significant value-added to users (i.e., the benefits of audits exceed their cost – see Section 9), even if there are limits on that value-added.

134. The word “limitations” describes the furthest or utmost extent, range, boundary, demarcation or degree, etc. beyond which an activity or function cannot or may not proceed: i.e., a restriction or restrictions causing something to fall short[47] of what may otherwise be expected or desired. The word “inherent” describes a permanent and essential element or quality of something, i.e., an inseparable part, element or quality because it belongs to the very nature of something[48]. On this basis, the term *inherent limitations of an audit* refers to restrictions on the activity, function or value of an audit inseparable from an audit because these restrictions belong to its very nature. This Paper applies the concept of the financial reporting supply chain in its further analysis of the inherent limitations of an audit and develops a categorisation of inherent limitations based upon this perspective.

5.3. Nature of Inherent Limitations of an Audit

135. Some inherent limitations are beyond the control of auditors. Such inherent limitations arise primarily from parts of the financial reporting supply chain (see Section 3.2.3 in this Paper and the Appendix to this Paper) other than audit process. Auditors may have greater ability to control, and hence mitigate, in varying degrees, inherent limitations arising from some constraints on audit inputs and audit processes, but this does not mean that the inherent limitations arising from such constraints can be eliminated. General inherent limitations are those inherent limitations that are pervasive to an audit and affect many different assertions, kinds of assertions, or audit issues. Specific inherent limitations are the manifestation of general inherent limitations for specific assertions, kinds of assertions, or audit issues.

136. The nature of the inherent limitations of an audit resulting from the financial reporting supply chain are closely bound up with very basic cost/benefit decisions that a society makes. Some inherent limitations (e.g., limitations on the role or coverage of audits) are generated indirectly by the basic cost/benefit decisions made by the participants in the financial reporting supply chain (e.g., limitations on the role or coverage of audits when defining what a financial statement audit constitutes). Other inherent limitations result from further cost/benefit decisions by society. For example, a decision by society for accrual accounting financial reporting frameworks that involve accounting estimates, as opposed to pure cash accounting financial reporting frameworks, gives rise to the inherent limitations associated with auditing accounting estimates).

137. The development of an exhaustive or comprehensive “list” of *specific* inherent limitations of an audit is not possible, because for every audit input, part of the audit process, use to which audit outputs are put, and the influence of various factors in the environment surrounding audits, lead to inherent limitations of audits. Furthermore, even if one were to restrict such a list to the audit process in relation to the financial statements and the results of that process alone, it becomes apparent that every assertion for the financial statements as a whole (e.g., the going concern assumption) or for a particular item in the financial statements (and each item in the financial statements represents a bundle of assertions in relation to the specific recognition, measurement, classification, presentation and disclosure criteria for that item as required by the applicable financial reporting framework) examined as part of an audit of those financial statements is subject to multiple specific inherent limitations. Some of these inherent limitations can be mitigated by means of the audit process more or less easily, or to a greater or lesser extent, than others, but nevertheless, these limitations exist, even if some

[47] Adapted from Funk & Wagnalls Canadian College Dictionary, (Fitzhenry & Whiteside Limited, Ontario, Canada, 1989), p. 785.

[48] Adapted from Funk & Wagnalls Canadian College Dictionary, (Fitzhenry & Whiteside Limited, Ontario, Canada, 1989), p. 694.

are more or less likely to be relevant, or more or less likely to occur, in some situations than others.

138. The completeness assertion in relation to a seemingly straightforward account balance such as cash is subject to a number of specific inherent limitations. For example, there may be an undisclosed bank account in the entity's name, where the auditor is intentionally not made aware of the bank as having a relationship with the entity, and where transactions in that bank account are not reflected in the entity's books and records. Such a misstatement would be extremely difficult to detect (an inherent limitation of an audit arising from a fraud risk). A second example might be the entity having closed out to the extent practicable (i.e., brought the cash balances to zero) of all accounts at a particular bank in a previous year with the intention of not continuing the relationship with that bank, but without actually closing down every account. In some jurisdictions, an unexpected and unusual sizeable cash receipt could be deposited onto such an account in a subsequent year without management being aware of it, and consequently failing to recognise the amount in the financial statements (an inherent limitation of an audit arising from a weakness in internal control over completeness of cash balances and receipts).

139. More complex issues, such as assertions in relation to the determination of fair values and other accounting estimates, would generate significantly more, or more severe, specific inherent limitations per assertion than the simple example above. This shows that an attempt to develop an exhaustive list of specific inherent limitations of an audit would lead to an endless exercise with an endless list. Accordingly, rather than developing an exhaustive list of *specific* inherent limitations of an audit, which is an unrealistic objective, this Paper seeks to identify the broad categories of *general* inherent limitations. Furthermore, this categorisation seeks to identify such general limitations that apply to the scope of the audit, multiple assertions in the financial statements, or the uses to which the financial statements and the auditors' reports are put, rather than to identify limitations specific to certain assertions for particular items in the financial statements. This approach helps to clarify the relationship between the inherent limitations of an audit and other basic concepts of an audit, such as audit evidence, audit risk, reasonable assurance, and professional judgment.

5.4. Nature of Categories of General Inherent Limitations of a Financial Statement Audit

140. The treatment and categorisations of inherent limitations of an audit are driven by the difference between what users would like to have in an ideal world and what audits can actually deliver (see paragraphs 132 and 133). This necessarily leads to very broad and comprehensive treatment of inherent limitations of an audit that explains the nature of reasonable vs. absolute assurance.

141. Comprehensiveness can best be achieved by taking a systems-based approach (using the concept of an environment around a system that comprises inputs, a process, and outputs)[49] to identifying inherent limitations of an audit in terms of their sources or as results, and to clarify the resulting categories and subcategories using examples. This implies there are two aspects reflecting the "two sides of a coin" to such comprehensiveness: sources of general inherent limitations and general inherent limitations in terms of impacts, which are closely linked.

[49] The suggestion to use a systems-based approach to help analyse audits is suggested by the FEE Issues Paper "Principles of Assurance: Fundamental Theoretical Issues With Respect to Assurance in Assurance Engagements" (FEE: Brussels, April 2003), pp. 262-266.

142. An emphasis on control and sources of inherent limitations allows a better treatment of the degree to which auditors exercise control over the inherent limitations. On the other hand, an emphasis on general inherent limitations as results or impacts helps clarify the effect of inherent limitations on audits. Both perspectives are important. Consequently, in this Paper, FEE chooses to address both perspectives. Nevertheless, because audit regulators regard the control that auditors exercise over inherent limitations to be an important issue, this Paper will focus the analysis of inherent limitations of an audit on the basis of control and sources of inherent limitations.

143. Using a systems-based approach emphasising ***control and sources*** of inherent limitations as described further in Section 5.5, FEE believes it to be useful to identify the following broad categories and subcategories of ***sources*** of general inherent limitations of an audit (the reference to "audit process" in the following categories encompasses all audit sub processes extending from the engagement acceptance sub process to the communication of audit results sub process):

Categorisation by Control and Source

a) General inherent limitations of an audit arising from matters not under the direct control of the auditor (5.5.1)
   (i) General inherent limitations arising from the environment surrounding audits and arising from the inputs to the audit process from parts of the financial reporting supply chain other than audits (5.5.1.1)
      - Legal, regulatory or auditing standards requirements defining audit coverage or scope (definition of audit object) (5.5.1.1.1)
      - Applicable financial reporting framework and entity activities and circumstances generating the audit object (financial statement assertions and related available evidence) (5.5.1.1.2)
      - Legal, regulatory and ethical prohibitions on auditor access to information(5.5.1.1.3)
      - Inherent limitations on internal control when substantive procedures are not enough (5.5.1.1.4)
      - Other environmental factors affecting, or other inputs to, the audit process, such as other legal or regulatory requirements for audits: (5.5.1.1.5)
   (ii) General inherent limitations arising from the users that use the outputs from the audit process (user decision-making from audit results) (5.5.1.2)

b) General inherent limitations of an audit arising from constraints on the control exercised by the auditor over audit inputs and the audit process (5.5.2)
   (i) General inherent limitations arising from constraints on the inputs brought into the audit process by the auditor (5.5.2.1)
   (ii) General inherent limitations arising from constraints on the audit process as conducted by the auditor (5.5.2.2).

In order to understand the nature of these categorisations, it is necessary to consult the further detailed descriptions thereof in the Sections noted. The treatment of inherent limitations of an audit as impacts is simpler and without catch-all categories. However, the focus in this Paper will be on the treatment of the categorisation of inherent limitations of an audit by source and whether, and to what extent, auditors exercise control over those sources of inherent limitations.

144. Using a systems-based approach emphasising the general inherent limitations as audit results or audit impacts described further in Section 5.6, FEE believes it to be useful to identify the following broad principles-based categories and subcategories of general inherent limitations of an audit:

Categorisation by Audit Impact

a) General inherent limitations on the audit opinion (5.6.1)
   (i) General inherent limitations on coverage or scope of the audit opinion (5.6.1.1)
   (ii) General inherent limitations on the nature, timing and strength of the audit opinion (5.6.1.2)
   (iii) General inherent limitations on the form and content of communication of the audit opinion (5.6.1.3)
b) General inherent limitations on the use to which the audit opinion is put by users (5.6.2).

In order to understand the nature of these categorisations, it is necessary to consult the further detailed descriptions thereof by Section as noted above.

145. The categories and subcategories of general inherent limitations of an audit for both perspectives (by control and source, and by audit results or impacts), are described using examples in greater detail in the following Sections below. This treatment also demonstrates the nature and extent of the interconnections between the different categories and different perspectives.

5.5. General Inherent Limitations of an Audit Categorised by Control and Sources

146. As noted in paragraph 143, the general inherent limitations of an audit categorised by control and sources can be divided in two broad categories: general inherent limitations of an audit arising from matters not under the direct control of the auditor, and general inherent limitations of an audit arising from constraints on matters over which the auditor exercises control. In examining some of the general inherent limitations arising from these sources, comparisons will also be drawn to two other professions that deal with similar issues at an abstract level: the legal and medical professions. This serves to clarify the nature of the inherent limitations arising from these sources. This categorisation is also the focus of the explanation of inherent limitations of an audit in this Paper.

5.5.1. General Inherent Limitations of an Audit Arising From Matters Not Under the Direct Control of the Auditor

147. As also noted in paragraph 143, the general inherent limitations of an audit arising from matters not under the direct control of the auditor can be classified further into the following subcategories: general inherent limitations arising from the environment (i.e., in particular, the financial reporting supply chain) surrounding audits and arising from the inputs to the audit process from parts of the financial reporting supply chain other than audits, and general inherent limitations arising from the users that use the outputs from the audit process (user decision-making from audit results).

5.5.1.1. General inherent limitations arising from the environment surrounding audits and arising from the inputs to the audit process from parts of the financial reporting supply chain other than audits

148. This subcategory covers both the inherent limitations arising from the environment surrounding audits and arising from inputs to audits because, without further basic academic research beyond the scope of this Paper (such as the development of a conceptual framework

for audits), it is virtually impossible to determine whether it is possible or useful to clearly delineate "inputs" into the auditing process from the environmental factors generating inherent limitations.

149. The Appendix to this Paper provides examples of the responsibilities of participants in the financial reporting supply chain other than auditors, that, with the exception of the treatment of users, represent inputs into the audit process or environmental factors, both of which are beyond the direct control of auditors. The most important sources of such inherent limitations are those resulting from: 1. legal, regulatory or auditing standards requirements with respect to audit coverage or scope (definition of audit object) 2. applicable financial reporting framework and entity activities and circumstances generating the audit object (financial statement assertions and related evidence available), and 3. legal, regulatory and ethical prohibitions on auditor access to information.

5.5.1.1.1. Legal, regulatory or auditing standards requirements defining audit coverage or scope (definition of audit object)

150. Audit coverage or scope refers to what an audit *is* based on what it is for, or on the role that it has. Audit coverage or scope is important because it delineates the responsibilities of an auditor of financial statements, and hence what the audit opinion covers. As noted in paragraph 188, audit coverage or scope delineates the subject matter information (financial statements) covered by the audit opinion, and hence the audit, from that which is not (other matters): it defines the object of the audit. What an audit is, is a function of what it is not. Consequently, from a financial reporting supply chain or financial reporting system perspective, inherent limitations arising from audit coverage or scope represent the boundaries of what an audit is. Section 3.2.2 describes the basis for, and the role of, financial statement audits and Section 3.3.2 describes the responsibilities of an auditor given the role of a financial statement audit based upon audit coverage or scope.

151. What an audit of financial statement entails in terms of coverage or scope is not an issue that auditors decide – it is beyond the control of auditors and represents the primary source of inherent limitations of an audit arising from the financial reporting supply chain. It is users and other stakeholders (that is, society as a whole) that ultimately decide whether audits of financial statements exist, and if so, what such audits ought to constitute based on overall cost/benefit considerations for society. The delineation of the role of audits and responsibilities of auditors are generally set forth in legal, regulatory, or auditing standards requirements. For this reason, from an auditing standards setting perspective – as opposed to a financial reporting supply chain or financial reporting system perspective – audit coverage and scope are not regarded as inherent limitations of an audit (this also applies to inherent limitations arising from the users that use the outputs from the audit process (user decision-making from audit results – see Section 5.5.1.2), but represent the basis for the treatment of the other inherent limitations of an audit (see paragraph 156).

152. Based upon their interpretation of the public interest in weighing the needs of different stakeholders, legislators or regulators in some jurisdictions have decided to prescribe audits of financial statements by means of statute or regulation. Legislation or regulation then also stipulates the coverage or scope of the audit, which may vary by jurisdiction. For example, the Fourth and Seventh EU Directives require that the financial statement audit for certain kinds of entities include not only the audit of the financial statements, but also an opinion (and hence an audit) of whether what the European Directives term the "annual report" of the

entity is consistent with the audited financial statements of that entity[50]. In the U.S.A., on the other hand, the Sarbanes-Oxley Act requires financial statement audits of SEC-Registrants to include not only an audit of the financial statements, but to also include an audit of management's assessment of internal control over financial reporting and of internal control over financial reporting[51]. However, common to the financial statement audits of all of the named and other jurisdictions is the requirement to have the financial statement audit include an audit of the financial statements. Auditing standards setters have based their standards for financial statement audits on this common aspect of all financial statement audits, based upon the standards setters' judgments about user needs and what such audits can, and ought to, deliver.

153. As noted in paragraph 79, the objective of a financial statement audit, and hence the responsibility of an auditor, is to express an opinion on whether the financial statements as a whole have been prepared and presented in accordance with the applicable financial reporting framework. To discharge this responsibility, through the audit the auditor obtains reasonable assurance about whether the financial statements as a whole are free of material misstatement and reports on the findings thereon resulting from the audit. As noted in paragraph 80, the auditor expresses a professional (expert) opinion on whether the financial statements as a whole have been prepared and presented in accordance with the applicable financial reporting framework.

154. Consequently, the auditor's conclusion represents an opinion – not a statement of fact, – because of the inherent imprecision involved in financial reporting and auditing. Furthermore, such a professional (expert) opinion does not constitute a final judgment on the matter (which is the responsibility of courts of law, in those rare circumstances when the matter comes before the courts) Neither does such a professional (expert) opinion constitute a guarantee – that is, the auditor is not acting as insurer for those using the financial statements if the financial statements turn out to be materially misstated subsequent to the issuance of an unmodified auditor's opinion.

155. Generally, unless there are legal, regulatory ethical or other professional requirements to the contrary, an audit does *not* encompass an opinion, for example, on the:

- Effectiveness of internal control or corporate governance;
- Economy, efficiency or effectiveness of operations;
- Future performance of the entity; or
- Future viability of the entity beyond the appropriateness of the use of the going concern assumption in the preparation and presentation of the financial statements.

156. Inherent limitations resulting from audit scope or coverage exist independent of user expectations. For example, users may not expect audits to encompass an opinion on the future performance of the entity, but that does not imply that therefore audit scope or coverage is not an inherent limitation. Furthermore, audit scope or coverage as an inherent limitation becomes particularly important when defining whether an assurance engagement, such as an audit, is indeed possible. Assurance engagements such as audits can only be undertaken when the scope or coverage of those engagements do not encompass opinions on subject matter information without suitable criteria for forming such an opinion, for

[50] Directive 2003/51/EC of the European Parliament and of the Council of 18 June 2003 amending Directives 78/660/EEC, 83/349/EEC, 86/635/EEC and 91/674/EEC on annual and consolidated accounts of certain types of companies, banks and other financial institutions an insurance undertakings, Article 1 (18) inserting Article 51a into Directive 78/660/EEC and Article 2 (11) replacing Article 37 in Directive 83/349/EEC.

[51] Sarbanes-Oxley Act of 2002, Section 404 (b) and Section 103 (a) (2) (A) (iii); PCAOB Auditing Standard AS-2.

example[52]. In addition, the definition of audit object through audit scope or coverage has a major impact on the evidence available and obtainable by auditors (see Section 6.2.1), and hence on the level of assurance that can be obtained (see Section 6.3.2). Consequently, the inherent limitations resulting from audit scope or coverage represent the *primary* inherent limitations from which all other inherent limitations flow.

157. Consequently, inherent limitations of an audit resulting from audit scope or coverage are limitations that constitute legitimate restrictions on the responsibilities of auditors and the coverage of their opinion. It is the definition of audit scope or coverage by laws, regulations and auditing standards that define the audit object: the financial statement assertions and related available audit evidence subject to audit.

5.5.1.1.2. Applicable financial reporting framework and entity activities and circumstances generating the audit object: financial statement assertions and related available evidence

158. Accounting standards setters promulgate the financial reporting framework applied by preparers in the preparation and presentation of the financial statements, which are then audited by the auditor to determine whether the financial statements have been prepared and presented in accordance with that framework. Auditors are not in a position to directly control the content of a financial reporting framework and therefore cannot improve deficient financial reporting frameworks, particularly where these are prescribed by accounting regulators for use by preparers.

159. However, financial reporting frameworks are not applied in a vacuum. The nature of the entity (the entity's operations, its ownership and governance, the types of investments that it is making and plans to make, the structure of the entity and how it is financed), and in particular, the nature of the entity's operations, have a direct impact on the nature of the transactions that the entity enters into and the kinds of other events to which it is subject, both of which have an impact on the application of the requirements of the applicable financial reporting framework. Hence, the nature of the entity has a direct impact on the financial statement assertions that are, or ought to be, in the financial statements and the related audit evidence available, and therefore has a direct impact on the audit process. The auditor has no control over the nature of the entity, or over the nature of the transactions that the entity enters into and the kinds of other events to which it is subject, and therefore must deal with the transactions and other events and their treatment by the financial reporting framework as they are. This situation leads to the inherent risk component of misstatement risk, as described in paragraphs 109 to 118, which is beyond the control of the auditor.

160. When opining on a set of facts or circumstances, there are inherent limitations, independent of the process applied, on the ability of professionals to obtain certainty (and hence conclusive evidence) about whether their opinion about the application of the criteria to the facts and circumstances is, in fact, the right one. This also applies in audits to the application of the requirements of a financial reporting framework to the transactions and other events, and circumstances or conditions, of an entity. Paragraphs 191 to 194 allude to this kind of inherent limitation.

161. When an auditor expresses an audit opinion, the auditor bases that opinion on a series of determinations as to whether the accounting treatment presented (the specific accounting assertions in relation to recognition, measurement, classification, presentation and disclosure) in an entity's financial statements (a bundle of assertions: the subject matter

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[52] See IFAC, Handbook of International Auditing, Assurance, and Ethics Pronouncements, International Framework For Assurance Engagements (IFAC: New York, 2006), pp.287-300, for a discussion of the elements necessary for an assurance engagement.

information) of particular transactions and other events, and circumstances or conditions (the subject matter), in relation to that entity can be subsumed under particular requirements of the applicable financial reporting framework (the criteria)[53]. It is the application of the criteria to the subject matter that yields the available evidence to support the subject matter information[54].

162. The requirements of the financial reporting framework invariably require significant interpretation and hence judgment on the part of management and the auditor (even when the auditor draws upon interpretations of accounting standards and prevailing practice), as does the actual nature of the transactions and other events, and circumstances or conditions, of the entity. Consequently, the application (subsumption) of the requirements of the financial reporting framework to those transactions and other events, and circumstances or conditions requires considerable interpretation and hence judgment on the part of the auditor. Consequently, the more the auditor's judgment becomes subject to greater uncertainty (and the audit evidence less persuasive), the more the auditor cannot be sure about whether the decisions reached would be supported by others, such as, in rare circumstances, accounting oversight authorities or the courts. Such uncertainty means that the available evidence about the assertions (both resulting from the application of the criteria to the subject matter) is often not conclusive. Of course, absolutely conclusive evidence (no doubt) does not exist in the real world and would constitute omniscience (including the ability to predict the future).

163. In other words, there are inherent limitations independent of the audit process on the ability of the auditor to obtain conclusive audit evidence and hence obtain and convey comfort about whether the financial statements are prepared and presented in accordance with the applicable financial reporting framework (i.e., limitations on the "strength" of the audit opinion). The greater the need for interpretation, the greater the uncertainties and the less conclusive the audit evidence, and hence the greater the inherent limitations on the auditor's opinion and the greater the need for the auditor to apply professional judgment. These uncertainties and hence the less than conclusive available audit evidence stem from the inherent imprecision of the subject matter (the transactions and other events, and circumstances or conditions, of the entity), the criteria (the specific requirements of the financial reporting framework with respect to recognition, measurement, classification, presentation and disclosure of matters in the financial statements), and the application of the criteria to the subject matter.

164. Overall, the nature and strength of the evidence available for the financial statement assertions depend upon the nature of the entity and the requirements of the financial reporting framework. Both are beyond the control of the auditor and represent sources of inherent limitations of an audit that cannot be overcome by the auditor, but that auditors try to mitigate through the application of professional judgment.

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53 For a treatment of the relationship between subject matter, criteria and assertions, see the FEE Issues Paper "Principles of Assurance: Fundamental Theoretical Issues With Respect to Assurance in Assurance Engagements" (FEE: Brussels, April 2003), pp. 203-230. For description of subject matter information, see IAASB, "International Framework for Assurance Engagements", from Handbook of International Auditing, Assurance, and Ethics Pronouncements, 2006 Edition (IFAC: New York, 2006), paragraph 8.

54 For a treatment of the relationship between subject matter, criteria and assertions on the one hand, and evidence on the other hand, see the FEE Issues Paper "Principles of Assurance: Fundamental Theoretical Issues With Respect to Assurance in Assurance Engagements" (FEE: Brussels, April 2003), pp. 231-256.

5.5.1.1.3. Legal, regulatory and ethical prohibitions on auditor access to information

165. There are legal, regulatory and ethical prohibitions on auditor access to information (which, in fact, forms a fundamental premise of an audit: see paragraph 77), which represent the single greatest inherent limitation of an audit resulting from other environmental factors affecting, or other inputs to, the audit process that are beyond the control of the auditor, which is in part caused by the limited sanctions that auditors can impose on the entity or others. With some possible exceptions in the public sector for courts of auditors, auditors of financial statements are only given documents and explanations provided by management and other third parties on a voluntary basis – that is, auditors can never be certain that management or other parties have provided them with all of the documents and information needed for the audit. Furthermore, auditors can obtain verbal or written confirmations from third parties only on a voluntary basis.

166. Auditors have no legal power or authority to:

- Subpoena witnesses or require the production of documents;
- Have individuals provide statements under oath;
- Engage in cross-examination type of inquiry like the police, public prosecutors or the courts;
- Seize documents or other evidence like the police, public prosecutors or the courts; or
- Impose sanctions on the entity (or management) beyond the auditor's report, or on third parties at all, such as the courts and some regulators can, if required documents or information is not forthcoming or were not a fair representation of actual events or circumstances.

Needless to say, these limitations on an auditor's power and authority result in severe inherent limitations on the audit process, but they are appropriate limitations given society's decisions on the costs and benefits of audits. For the purposes of this Paper, the audit evidence available from the application of the applicable financial reporting framework to the transactions, other events, and circumstances or conditions of the entity less that portion of the available evidence to which an auditor is not actually given access is called "obtainable evidence".

167. Furthermore, ethical requirements may restrict an auditor's access to information. For example, independence requirements may hinder the most knowledgeable individual within a firm from being involved in the performance of an audit. Consequently, although such ethical requirements are designed to act as safeguards against threats to objectivity, it should be recognised that such safeguards may have other undesirable impacts on audit quality by causing threats against competence: they are not without cost.

5.5.1.1.4. Inherent limitations on internal control when substantive procedures are not enough

168. Another inherent limitation of an audit resulting from other environmental factors affecting, or other inputs to, the audit process beyond the control of the auditor is the need to audit accounting assertions for which substantive procedures alone are not enough to provide the audit evidence needed to support the audit conclusion (e.g., in relation to the completeness assertion). In these circumstances, these assertions cannot be audited without taking the adequacy of internal control over that assertion into account. Audits are based on the premise that preparers (that is, professional accountants in industry, and management) have a responsibility to design, implement and maintain adequate internal control relevant to the preparation and presentation of the financial statements in accordance with the applicable financial reporting framework (see paragraph 76). As control theory points out, controls are subject to inherent limitations per se, but internal control involving human beings are

particularly prone to the same inherent limitations to which human beings are subject (unreliability), even though their involvement generally makes a control more stable for unexpected inputs. The design, implementation and maintenance of internal control in response to inherent risk leads to the control risk component of misstatement risk. Paragraphs 114 to 117 discuss control risk and the inherent limitations of internal control. As described in paragraphs 109 to 118, control risk is beyond the control of the auditor. Hence, the inherent limitations of internal control when substantive procedures are not enough represent a source of inherent limitations of an audit.

169. However, this is not to suggest that auditors cannot respond to this limitation. If, for example, tests of design, implementation and operating effectiveness of internal control were to result in the conclusion that internal control is not adequate in situations where substantive procedures alone do not suffice to obtain sufficient appropriate audit evidence, then an auditor cannot mitigate control risk. In such circumstances, the auditor can respond by drawing the appropriate consequences for the auditor's report.

5.5.1.1.5. Other environmental factors affecting, or other inputs to, the audit process, such as other legal or regulatory requirements for audits

170. The audit process, in the broadest sense of the word, refers to the ability of the auditor to obtain comfort (and hence strength of the audit evidence) about the appropriateness of the auditor's opinion and to communicate that opinion. Although the audit process includes engagement acceptance and communication sub processes, the core of the audit process involves the determination of materiality, risk assessment procedures and further audit procedures in response to assessed risks: in other words, the acquisition of audit evidence. In essence, audits involve a kind of "investigation" (the audit process) to gather evidence upon which the auditor bases the auditor's opinion. The audit process involves the design of the nature, timing and extent of audit procedures that the auditor then performs to obtain audit evidence.

171. It may be useful to distinguish between general audit processes (sub processes or other parts of the audit process) versus the specific means (the procedures) by which an auditor discharges his obligations. From this perspective, the audit process represents a more or less continual course or method of operation or series of related actions, undertaken by the auditor to fulfil the auditor's responsibilities in relation to the audit engagement[55]. The audit procedures, on the other hand, represent those individual related actions (rather than the series) undertaken by the auditor to discharge those responsibilities. Whereas the conduct of audit processes and sub processes is required of the auditor and the auditor must perform procedures to conduct those processes and sub processes, there are different procedures by which the auditor can conduct those processes and sub processes.

172. Certain sources of inherent limitations are beyond the control of the auditor and reflect society's decisions about the costs and benefits of audits. As noted in paragraph 173 in connection with paragraph 181, where statutory or regulatory requirements effectively set deadlines for audits within a certain time period after the date of the financial statements, audits must be designed to generally meet those deadlines, unless there are specific circumstances in the particular entity whose financial statements are being audited that preclude the auditor from achieving that deadline.

[55] For a treatment of the audit process, see the FEE Issues Paper "Principles of Assurance: Fundamental Theoretical Issues With Respect to Assurance in Assurance Engagements" (FEE: Brussels, April 2003), pp. 257-278.

173. Further examples of such inherent limitations beyond the control of the auditor are audit requirements for particular kinds of entities set by accounting regulators (e.g., the Fourth and Seventh EU Directives), which, for example, may specify the deadlines by which financial statements must have been prepared and presented by management or even the deadline by which audited financial statements must have been filed by management with regulatory authorities. Such audits must then be designed to generally meet those deadlines, unless there are specific circumstances in the particular entity whose financial statements are being audited that preclude the auditor from achieving that deadline. Auditors cannot control such deadlines, but such deadlines have a direct impact on the audit process by determining the kinds of audit evidence available, or obtainable, by the auditor, which is another source of inherent limitations of an audit.

5.5.1.2. *General inherent limitations arising from the users that use the outputs from the audit process (user decision-making from audit results)*

174. As the FEE Paper "Principles of Assurance" points out, the user profile (characteristics of users) has a direct impact on the understandability of information – that is, the degree to which information communicated is understood by recipient users. Since auditors have no control over the characteristics of users, for audits of general purpose financial statements to be a practicable exercise, such audits are performed under certain assumptions about the user profile for financial statements and the auditors' reports (see paragraphs 97 and 98) for relevant classes of users. At least for general purpose financial statements, it would not be practicable to design an audit for each individual user: consequently, such audits are designed under assumptions about users as a group: that is, for classes of users. However, the users as a group may nevertheless have characteristics, beyond the control of the auditor, that may cause these users to misuse or misinterpret both the financial statements and the accompanying auditor's report for decision-making purposes.

175. Furthermore, as mentioned in paragraph 197, an auditor has no control over the use to which an audit opinion is put by users (this is because audits are not designed to do so: see the discussion on audit scope or coverage), which means that users can, and sometimes do, misuse financial statements and the accompanying audit opinions in their decision-making processes in relation to the entity. As noted in paragraph 196, auditors may seek to reduce the risk of this misuse by improving auditor communication in the auditor's report, there are clear limitations on the ability of an auditor to do so. Consequently, the inability of an auditor to control the use to which users put an audit opinion is a general inherent limitation of an audit. However, as noted in Section 5.5.1.1.1, this only applies when taking a financial reporting supply chain or financial reporting system perspective, as opposed to an auditing standards setting perspective.

176. Overall, one of the greatest inherent limitations on the value-added of audits may be that users of financial statements and auditors' reports do not understand them adequately, which causes their misuse.

5.5.2. *General Inherent Limitations of an Audit Arising From Constraints on the Control Exercised by the Auditor over Audit Inputs and the Audit Process*

177. Some general inherent limitations of an audit arise from constraints on the control exercised by the auditor over audit inputs and the audit process: this implies that the auditor is not in a position to exercise full control over these matters, because constraints arising from the financial reporting supply chain may have an impact on the flexibility with which auditors

can exercise their control. Such inherent limitations may arise from two subcategories of sources: 1. general inherent limitations arising from constraints on inputs brought into the audit process by the auditor, and 2. general inherent limitations arising from constraints on the audit process as conducted by the auditor.

5.5.2.1. General inherent limitations arising from constraints on inputs brought into the audit process by the auditor

178. There are constraints on the inputs brought into the audit process by the auditor. These constraints also cause general inherent limitations. An example of an input brought into the audit process by the auditor is the competence of the engagement team. Under ISQC 1.42, an audit firm has the responsibility to implement and maintain quality control policies designed to require that an audit engagement partner has the appropriate competence to perform the role[56], and under ISQC 1.44 an audit firm also has the responsibility to assign appropriate staff with the necessary competence to perform audit engagements in accordance with professional standards and regulatory and legal requirements and to enable the firm or audit engagements partners to issue audit reports that are appropriate in the circumstances[57]. Furthermore, under ISA 220.19 the audit engagement partner should be satisfied that the engagement team has the appropriate competence to perform the audit engagement in accordance with the professional standards and regulatory and legal requirements, and to enable the issuance of an auditor's report that is appropriate in the circumstances[58].

179. ISA 620 requires auditors to obtain sufficient appropriate audit evidence that work performed by an expert that is used by the auditor is adequate for the purposes of the audit[59]. Nevertheless, in the case of experts, there are constraints on the flexibility of an auditor to control the competence of the engagement team, which therefore constitute an inherent limitation of an audit, even when an auditor can and does exercise control. For example, auditors are not necessarily the final arbiters of what constitutes competence in a particular field of expertise (that is the responsibility of educators and education standards setters in that field), nor may auditors be competent (nor expected to be competent) to assess certain areas of competence (e.g., law, actuarial mathematics geology, etc.). This is an inherent limitation resulting from a constraint from the financial reporting supply chain.

180. Furthermore, there may be legitimate cost/benefit constraints that cause auditors to assume some risk (albeit low) of inadequate competence in relation to particular expertise that also constitute an inherent limitation of an audit that is acceptable even though auditors have control over the matter. For example, the firms often rely on external credentials from educators and education standards setters and engagement partners rely on the firm's systems of quality control established in compliance with ISQC 1 in vetting those credentials, rather than having the firms re-examine members of the engagement team for every area of required competence or, even worse, having the engagement partner do so, which would be prohibitive in both terms of time and cost. This is an example of an inherent limitation of an audit over which auditors exercise control, but where society would accept the auditor not exercising that control to its full extent for legitimate cost/benefit constraints.

[56] IFAC, IAASB ISQC 1.42, 2007.
[57] IFAC, IAASB ISQC1.44, 2007.
[58] IFAC, IAASB ISA 220.19, 2007.
[59] IFAC, IAASB ISA 620 "Using the Work of an Expert", 2007, paragraph 2.

5.5.2.2. General inherent limitations arising from constraints on the audit process as conducted by the auditor

181. There are constraints on the audit process as conducted by the auditor; general inherent limitations arise from such constraints. An example of a matter over which an auditor has control, subject to constraints such as a legal filing deadline for filing audited financial statements, in relation to the audit process as conducted by the auditor is the time frame for audit completion and reporting. As noted in paragraph 173, such a deadline has a direct impact on the audit process by determining the kinds of audit evidence available, or obtainable by the auditor, which is another inherent limitation of an audit beyond the control of the auditor.

182. On the other hand, auditors do have considerable flexibility on the time frame for audit completion and reporting in the time period between the date of the financial statements and the regulatory reporting deadline, unless there are specific circumstances in the particular entity whose financial statements are being audited that preclude the auditor from achieving that deadline. Within this time frame, it is the trade-off between desires of users of the financial statements and auditor's report (and hence management) for information that is as up-to date as possible and the need to have adequate time for the completion of the audit process, or to obtain higher quality audit evidence, that determine the time needed for completion. Consequently, the inherent limitations involve some tradeoffs between the relevance and reliability of the audit evidence and hence of the audit opinion: an audit must be completed on a timely basis before the information subject to audit is no longer useful for decision making.

183. This implies that compared to, for example, legal proceedings, a certain degree of reliability must be sacrificed for timeliness. If audits were to be completed several years after the period covered by the financial statements being audited, many matters involving judgments about future events would have been resolved. The audit opinion would likely be more reliable, but would no longer be relevant. Some support the view that audits ought to be delayed for particularly risky enterprises so that auditors can perform more, or more effective procedures (e.g., waiting for the outcomes) to improve the reliability of the audit opinion. On the other hand, investors want audited information about risky enterprises sooner, rather than later. This is a public interest issue that the investing public needs to decide. In this case, the auditor acts as an "executor" that balances stakeholder interests between relevant versus reliable information: it is the desires of stakeholders and the deliverability of an adequate audit within a certain time frame that guide auditor decisions as to the appropriate time needed for audit completion and reporting.

184. Another constraint on the flexibility of an auditor associated with the audit process, but where the auditor acts as an executor of the public interest by attempting to balance stakeholder desires about costs and benefits with the deliverability of an adequate audit, is the issue of economy. Society cannot bear unlimited costs for audits. Not only should audit costs not exceed the benefits from audits, but also the marginal cost of additional audit effort by the auditor should not exceed the marginal benefit of that effort. Audit effort (and hence the acquisition of audit evidence) is subject to diminishing returns. This implies that auditors should not attempt to gain all of the audit evidence obtainable because the benefit of obtaining it would not be worth the costs.

185. The implications for the audit process of the need for audits to be economical and timely are the primary reasons for:

- Audits rarely involving, and auditing standards generally not requiring, the authentication of documents and the acceptance by the auditor of the records and documents as genuine unless there are indications to the contrary (see paragraph 83);
- The use of audit testing (not just in a sampling sense – without the ability to test rather

than perform 100% examinations, audit time and costs would be astronomical);
- The application of a risk-based audit approach (since misstatements do not generally occur randomly – some financial statement assertions are subject to greater risks of material misstatement than others); and
- The reduction in the extent of further substantive audit procedures on the expectation that internal controls are operating effectively (if such effectiveness is tested by the auditor).

If these measures saving time and costs were not employed on audits, then an auditor would have to perform forensic-type substantive audit procedures on every transaction and other event, and circumstance or condition of the entity that may affect the financial statements. This would cause audit costs and the length of time needed to complete audits to be of a completely different order of magnitude than audits currently, and thereby cause the costs of audits to be greater than their benefits: audits would be irrelevant to users.

5.6. General Inherent Limitations of an Audit Categorised as Impacts

186. As noted in paragraph 144, the general inherent limitations of an audit categorised as impacts can be divided in two broad categories: general inherent limitations on the audit opinion, and general inherent limitations on the use to which the audit opinion is put by users. These categories can then be subcategorised as noted.

5.6.1. General Inherent Limitations on the Audit Opinion

187. The general inherent limitations on the audit opinion can be subcategorised into:

(i) General inherent limitations on coverage or scope of the audit opinion;
(ii) General inherent limitations on the nature, timing and strength of the audit opinion; and
(iii) General inherent limitations on the form and content of communication of the audit opinion.

5.6.2. General inherent limitations on coverage or scope of the audit opinion

188. The general inherent limitations on coverage or scope of the audit opinion reflect the inherent limitations of a financial statement audit based upon how a financial statement audit is defined in terms of the role such an audit and hence on what responsibility the auditor assumes in expressing an audit opinion: it delineates the subject matter information (the financial statements) covered by the audit opinion from that which is not (e.g., other unaudited information accompanying the financial statements). The definition of a financial statement audit depends upon the role of an audit as defined in statute or regulations for statutory audits, or on the definition of the service "financial statement audit" in auditing and professional standards based upon standards setter judgments about user needs and what such audits can, and ought to, deliver. The inherent limitation of an audit in this case results from the subject matter information not covered by the audit opinion and the limitation in the value-added on audits for users that result. Section 5.5.1.1.1 provides a somewhat deeper treatment of this issue from the point of view of the sources of this inherent limitation.

5.6.3. *General inherent limitations on the nature, timing and strength of the audit opinion*

189. These relate to limitations on the content of the opinion for the subject matter information (the financial statements) covered by that audit opinion. The content of the opinion can only be limited in terms of the nature, timing and strength of that opinion on the subject matter information. An example of limitations on the timing of the audit opinion is provided in paragraph 173 in connection with paragraphs 181 to 183.

190. An example of a limitation on the nature of the audit opinion results from the interaction between the applicable financial reporting framework and the facts and circumstances of the entity. If, for example, the applicable financial reporting framework were not to include associated entities (defined for the purposes of this argument as an entity over which the reporting entity has significant influence, but not control) within the framework's definition of related parties, but requires the disclosure of nature and extent of related party transactions in the notes to the financial statements, then the financial statements of the entity that has engaged in transactions with an associated entity need not include such disclosures for that entity because those disclosures are not required by the applicable financial reporting framework, unless the applicable financial reporting framework is a fair presentation framework and the nondisclosure of these transactions affects the fair presentation of the financial statements. Consequently, the auditor would not be in a position to modify the auditor's opinion in these circumstances unless the applicable financial reporting framework is a fair presentation framework and the nondisclosure of these transactions affects the fair presentation of the financial statements (nor would the auditor be in a position to modify the auditor's opinion unless the financial reporting framework is a compliance framework and this nondisclosure causes the financial statements to be misleading in the circumstances). This constitutes an inherent limitation on the nature of the audit opinion essentially caused by the requirements of the applicable financial reporting framework and the facts and circumstances of the entity.

191. The strength of the audit opinion depends upon the risks of misstatement in the financial statements (which are beyond the control of the auditor, as noted in paragraph 117), the ability of the auditor to identify and assess misstatement risks, and the effectiveness of the responses of the auditor to mitigate those risks. In other words, the strength of the audit opinion, which is also called the "assurance obtained" (see Section 6.3.20 for a discussion of audit assurance), results from the extent and strength of the audit evidence obtained from the responses of the auditor to support that opinion.

192. With the exception of the risks arising from agency theory, and the entity's control environment, risk assessment process, and monitoring of controls, the ability of the auditor to identify and assess misstatement risks, and the effectiveness of the responses of the auditor to mitigate those misstatement risks is subject to some of the same inherent limitations to which internal control (and in particular, entity control activities) are subject. This is because, in a sense, an audit represents an "external control activity".

193. An example of a situation in which both control activities and audit procedures would be of limited effectiveness would be a complex sales contract used as the basis for determination of revenue recognition. Even after having obtained a legal opinion on the legal rights and obligations currently extant under the sales contract at the financial statement date, as well as accounting experts comparing the terms of the contract to applicable accounting standards and practice, both the preparer of the financial statements and the auditor may find that, in their opinion, the weight of evidence supporting recognition under applicable accounting standards and practice may be only slightly greater than that not supporting recognition, or vice-versa. This situation is grey, rather than black and white. Yet, both the preparer and auditor must reach a decision on the matter using professional judgment based upon the preponderance of the evidence. In these circumstances, neither management nor the auditor

can claim to have reached an opinion with such strength that a court, regulator, standards setter, professional body or other preparers or auditors might not take a different view.

194. As noted in paragraph 116, to the extent that risks of material misstatement for particular assertions in the financial statements are independent of one another, the risk of material misstatement for the financial statements as a whole cannot be less than the risk of material misstatement for the assertion with the greatest such risk. This also applies to the risk that the auditor's response to the misstatement risk is not sufficiently effective. Consequently, the strength of the audit opinion on the financial statements as a whole cannot be greater than the strength of the audit conclusions for which the misstatement risk, and therefore the ineffectiveness of the auditor's responses to that risk, are the greatest. Hence, there are inherent limitations on the strength of an audit opinion.

195. The example of the inherent limitation on the nature of the audit opinion described in paragraph 190 and the example of the inherent limitation on the strength of the audit opinion described in paragraphs 191 and 194 both relate to the inherent limitations arising from the financial statement assertions and available evidence as described in greater detail in Section 5.5.1.1.2.

5.6.4. General inherent limitations on the form and content of communication of the audit opinion

196. Since auditors have no control over the characteristics of users, at best auditors can seek to mitigate somewhat (but cannot eliminate) the effects of user characteristics as a group that may be detrimental to the appropriate use of audit reports through clear communication in the auditor's report. There are limits on the nature and extent of communication (the information profile)[60] between auditors and users. For example, theoretically (ignoring, for a moment, confidentiality), an auditor could communicate the entire audit documentation to users. However, users are likely to be unwilling or unable to digest this communication: users would be subject to information overload. On the other hand, communication by the auditor that is too concise may lead to oversimplification and hence misinterpretation on the part of users of the basis for, and nature of, the audit opinion. Hence, efforts by auditors to achieve clear communication in an auditor's report involve their own inherent limitations, for there is often a trade-off between comprehensiveness of communication and information overload on the one hand, and the accurate communication of complex issues and misinterpretation risk on the other hand[61]. As a result, there are general inherent limitations on the form and content of useful communications of the audit opinion arising from users.

5.6.5. General Inherent Limitations On Use to Which Audit Opinion is Put By Users

197. An auditor has no control over the use to which an audit opinion is put by users, which means that users can, and sometimes do, misuse financial statements and the accompanying audit opinions in their decision-making processes in relation to the entity. Although auditors may seek to reduce the risk of this misuse by improving auditor communication in the auditor's report, there are clear limitations on the ability of an auditor to do so (see paragraphs 175 and 196). Consequently, the inability of an auditor to control the use to which users put an audit opinion represents a general inherent limitation.

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[60] FEE Issues Paper "Principles of Assurance: Fundamental Theoretical Issues With Respect to Assurance in Assurance Engagements" (FEE: Brussels, April 2003), pp. 188-190 and p. 199.

[61] These issues are touched upon in the FEE Issues Paper "Principles of Assurance: Fundamental Theoretical Issues With Respect to Assurance in Assurance Engagements" (FEE: Brussels, April 2003), pp. 289-300.

5.7. General Versus Specific Inherent Limitations of an Audit

198. As noted in paragraph 135, general inherent limitations are those inherent limitations that are pervasive to an audit and affect many different assertions, kinds of assertions, or audit issues: specific inherent limitations are the manifestation of general inherent limitations for specific assertions, kinds of assertions, or audit issues. It is possible to "map" general inherent limitations to examples of specific inherent limitations for specific assertions, kinds of assertions or audit issues. In the following Sections, this Paper shows examples of how general inherent limitations can be mapped for specific issues in which inherent limitations are of particular importance: fraud, related parties, accounting estimates (including fair value measures and disclosures), and the going concern assumption.

199. The following Sections show that different categories of inherent limitations result in more severe specific inherent limitations for some audit issues and risks (e.g., fraud and related parties) than for others. This means that the degree to which inherent limitations can be identified, assessed and mitigated by the auditor is more limited for those issues and related risks. Not every general inherent limitation necessarily leads to an important specific inherent limitation for a particular audit issue. Consequently, not every general inherent limitation is addressed for each issue.

5.7.1. Specific Inherent Limitations for Risks of Misstatement Arising from Fraud

200. The following table shows some of the connections between the categorisation of general inherent limitations of an audit and some examples of the specific inherent limitations in relation to the risks of misstatement arising from fraud:

Sources	**Issues**	**Specific Inherent Limitation**
Beyond Auditor Control		
Legal, regulatory or auditing standards requirements with respect to audit coverage or scope; applicable financial reporting framework and entity activities and circumstances generating the audit object: financial statement assertions and related available evidence to support these	Audits designed to detect material misstatements in the financial statements due to fraud	See the inherent limitations in this column
	Audits not designed to detect fraud not resulting in material misstatements in the financial statements	Audit will generally not detect fraud not resulting in material misstatements in the financial statements
Legal, regulatory and ethical prohibitions on auditor access to information	Inability to obtain information to appropriately assess risk of fraud or respond to that risk; in particular, cannot obtain adequate information about matters noted on the right	Difficulty in detecting collusion among senior levels of management and perhaps those charged with governance
		Difficulty in detecting intentional misrepresentations or intentional omission of information
		Difficulty in detecting collusion with third parties, which thereby causes external confirmations to become deceptive and hence unreliable

Inherent limitations on internal control when substantive procedures are not enough	Management override of internal control, which facilitates the actions on the right that are virtually impossible to detect by means of substantive procedures	Difficulty in detecting sophisticated and organised schemes to conceal fraud
		Difficulty in detecting deliberate failure to record transactions or executory contracts (completeness assertion)
Other environmental factors affecting, or other inputs to, the audit process, such as other legal or regulatory requirements for audits	Legal or regulatory deadlines for filing audited financial statements	Inability to await information confirming the outcome of events that may shed light on fraudulent activities affecting the financial statements
Inability of auditors to control users that use the outputs from the audit process	Users may view audits as guarantee in relation to the detection of management fraud	Inability of auditors to control investor behaviour when these fail to diversify investments despite risks of management fraud in individual entities; when losses due to management fraud occur, users project their disappointment upon auditors and audits, which brings these into disrepute. This loss in the reputation of auditors and audits then has a negative impact on the operation of capital markets by causing investors to request a risk premium for financial information that they no longer trust.
Constraints on Matters Over Which the Auditor Has Control		
Constraints on inputs brought into the audit process by the auditor	Auditors are generally not forensic experts trained in the authentication of documentation, nor are they expected to be	Difficulty in detecting forgery and falsification of documents and intentional misrepresentations about these and the circumstances they depict
Constraints on the audit process as conducted by the auditor	Balancing of benefits/costs of audit procedures and timing	Inability to perform forensic-type audit procedures for every transaction or circumstance

5.7.2. Specific Inherent Limitations for Risks of Misstatement Arising from Related Parties

201. The following table shows some of the connections between the categorisation of general inherent limitations of an audit and some examples of the specific inherent limitations in relation to the risks of misstatement arising from related parties:

Sources	**Issues**	**Specific Inherent Limitation**
Beyond Auditor Control		
Legal, regulatory or auditing standards requirements with respect to audit coverage or scope; applicable financial reporting framework and entity activities and circumstances generating the audit object: financial statement assertions and related available evidence to support these	Audits designed to detect material misstatements in the financial statements due to inappropriate accounting for, or disclosure, of related party relationships and transactions as defined by the financial reporting framework	See inherent limitations in this column
	Audits not designed to detect inappropriate accounting for, or disclosure, of related party relationships and transactions not defined as such by the financial reporting framework	Audit will generally not detect inappropriate accounting treatments or disclosure in relation to related party relationships or transactions not defined as such by the applicable fair presentation financial reporting framework
Legal, regulatory and ethical prohibitions on auditor access to information	Inability to obtain information to appropriately assess risk of unidentified related parties, related party relationships or transactions, and the appropriateness of the accounting for, or disclosure of, these matters	Inability to obtain sufficient information on the complex range of related party relationships and structures involving complex related party transactions, particularly from third parties
		Difficulty in detecting transactions not conducted in normal course of business due to lack of an exchange of consideration
		Difficulty in detecting incomplete identification of related parties, related party relationships and transactions
		Difficulty in determining appropriate accounting treatment or disclosure due to a lack of comparable market prices or other information that led to management's accounting treatment
Inherent limitations on internal control when substantive procedures are not enough	Management override of internal control, which leads to the problems noted on the right.	Difficulty in detecting informal related party transactions not documented or fully approved (e.g., with family members)
		Difficulty in detecting related parties, related party relationships or transactions because accounting system not designed to capture these
Other environmental factors affecting, or other inputs to, the	Legal or regulatory deadlines for filing audited financial	Inability to await information confirming the outcome of

audit process, such as other legal or regulatory requirements for audits	statements	events that may shed light on whether related party transactions were conducted at arm's length
Inability of auditors to control users that use the outputs from the audit process	Users may view audits as guarantee in relation to the detection of improper accounting for, or disclosure of, related party relationships and transactions	Auditors cannot prevent users from regarding the related party disclosure as providing assurance on the arm's length nature of those transactions, when in fact they do not, and suffer losses as a result. The resulting disappointment with auditors and audits then impacts the operation of capital markets.
Constraints on Matters Over Which Auditor Has Control		
Constraints on the audit process as conducted by the auditor	Balancing of benefits/costs of audit procedures and timing	Inability to perform wide-ranging procedures to identify the completeness of related parties, and related party relationships and transactions

5.7.3. Specific Inherent Limitations for Risks of Misstatement Arising from Accounting Estimates (including fair value measurements and disclosures)

202. The following table shows some of the connections between the categorisation of general inherent limitations of an audit and some examples of the specific inherent limitations in relation to the risks of misstatement arising from accounting estimates (including fair value measurements and disclosures)[62].

Sources	**Issues**	**Specific Inherent Limitation**
Beyond Auditor Control		
Legal, regulatory or auditing standards requirements with respect to audit coverage or scope; applicable financial reporting framework and entity activities and circumstances generating the audit object: financial statement assertions and related available evidence to support these	Audits designed to detect material misstatements in accounting estimates	See inherent limitations in this column
	Audits not designed to provide greater precision in the measurement of accounting estimates than provided by the circumstances of the entity and the requirements of the financial reporting framework, or to predict the outcome of future events or the assumptions about which underlie the determination of the accounting	The requirements of the financial reporting framework (which often only give general guidance on measurement methods and disclosures) and the circumstances of the entity means that there are often no precise means of measurement: uncertainty about the measurement is hence involved and the measurements are inherently imprecise

62 There may be specific inherent limitations arising from the accounting for, or auditing of, fair values not addressed in this table. However, this document is not designed to provide a complete listing, but only examples.

	estimate	Estimates are often made using assumptions about future conditions (e.g., market prices or future cash flows), transactions or events or regarding the outcome of events that may or may not occur or whose outcome is uncertain and will therefore be subject to change over time
		The measurement imprecision associated with an item or lack of objective data may make its measurement difficult to reasonably estimate
Legal, regulatory and ethical prohibitions on auditor access to information	Inability to obtain all of the information obtainable to properly measure the accounting estimate	Inability to obtain all of the information that ought to be obtainable (judgments about accounting estimates are made using the information obtained by the auditor at the time the judgments are made and do not involve taking responsibility for predicting future conditions, transactions or events, which, had they been known to the auditor at the time of the audit, may have had a significant impact on the actions or assumptions underlying the measurement of the accounting estimate)
		Inability to determine whether the entity needs to liquidate, curtail materially the scale of its operations, or undertake a transaction on adverse terms, which may affect the measurement of the accounting estimate
Other environmental factors affecting, or other inputs to, the audit process, such as other legal or regulatory requirements for audits	Legal or regulatory deadlines for filing audited financial statements	Inability to await information confirming the outcome of events that may shed light on whether the accounting estimates are measured appropriately
Inability of auditors to control users that use the outputs from the audit process	Users may view audits as increasing the precision of accounting estimates	Auditors cannot prevent users from basing investment decisions on the belief that major estimates are precise measurements, which, when the actual outcome differs from the estimate and this causes losses, may then have an impact on capital markets.

5.7.4. *Specific Inherent Limitations for Risks of Misstatement Arising from the Going Concern Assumption*

203. The following table shows some of the connections between the categorisation of general inherent limitations of an audit and some examples of the specific inherent limitations in relation to the risks of misstatement arising from the going concern assumption:

Sources	**Issues**	**Specific Inherent Limitation**
Beyond Auditor Control		
Legal, regulatory or auditing standards requirements with respect to audit coverage or scope; applicable financial reporting framework and entity activities and circumstances generating the audit object: financial statement assertions and related available evidence to support these	Audits designed to detect material misstatements in the financial statements due to inappropriate disclosure in relation to substantial doubt in relation to going concern or the inappropriate use of the going concern assumption	See inherent limitations in this column
		The assessment of the going concern assumption involves a judgment, at a particular point in time, about the future outcome of events or conditions that are inherently uncertain
		The degree of uncertainty associated with the outcome of an event or condition increases significantly the further into the future a judgment is being made about the outcome of an event or condition
		The size and complexity of an entity, the nature and condition of its business and the degree to which it is affected by external factors all affect the judgment regarding the outcome of future events or conditions
	Audits not designed to determine the future viability of the entity beyond the going concern assumption	Audit will generally not detect issues in relation to the future viability of the entity beyond the going concern assumption
Legal, regulatory and ethical prohibitions on auditor access to information	Inability to obtain information to appropriately assess risk of, and perform further audit procedures in relation to, inappropriate disclosure in relation to substantial doubt about the going concern assumption or about whether the going concern assumption is appropriate	Inability to determine whether the information obtained by the auditor upon which judgments about the future are made is complete
Other environmental factors affecting, or other inputs to, the audit process, such as other legal or regulatory requirements for audits	Legal or regulatory deadlines for filing audited financial statements	Inability to await information confirming the outcome of events that may shed light on whether the disclosures about substantial doubt in relation to the going concern assumption are appropriate, or

		whether the use of the going concern assumption is appropriate
Inability of auditors to control users that use the outputs from the audit process	Users may view audits as guarantee in relation to the future viability of the entity beyond the going concern assumption	Auditors cannot prevent users from basing investment decisions on the belief that audits are a guarantee in relation to the future viability of the entity beyond the going concern assumption; when losses due to such improper reliance occur, this may then affect the operation of capital markets
Constraints on Matters Over Which Auditor Has Control		
Constraints on the audit process as conducted by the auditor	Balancing of benefits/costs of audit procedures and timing	Inability to perform wide-ranging procedures to identify the completeness of evidence in relation to the going concern assumption
		Inability to perform further audit procedures at a later date when greater certainty about the outcome of events is available

5.8. The Treatment of Inherent Limitations of an Audit in the ISAs

204. At the present time, ISA 200 deals with the concept of inherent limitations of an audit in the Section on reasonable assurance and essentially uses such inherent limitations as an explanation as to why absolute (100 %) assurance cannot be achieved. No clear differentiation is made between the sources of inherent limitations of an audit and the inherent limitations as impacts on the audit, and in particular, as limitations on the audit opinion. Furthermore, no clear distinction is made between those inherent limitations over which the auditor has no control and those representing constraints on matters over which the auditor exercises control, and the mitigation of some inherent limitations by the auditor. There is no treatment of the limitation on access to information by the auditor[63]. An additional treatment of inherent limitations of an audit is provided in ISA 240[64], but this treatment also covers matters that apply to audits generally, even though they are of particular importance in relation to fraud. Overall, no distinction is drawn between the general inherent limitations of an audit and those limitations specific to certain audit issues.

205. The general inherent limitations of an audit as discussed in this Paper could form the basis for a more systematic treatment of general inherent limitations of an audit in ISA 200. In particular, a distinction may be drawn between general and specific inherent limitations and why a comprehensive list of specific inherent limitations cannot be developed. Furthermore, such a treatment may also distinguish between the sources of inherent limitations and the inherent limitations as audit impacts. The discussion of the sources ought to delineate the

[63] IFAC, IAASB ISA 200 “Objective and General Principles Governing An Audit of Financial Statements”, 2007, paragraphs 18-21.

[64] IFAC, IAASB ISA 240 (Redrafted) 2007, paragraphs 5-7.

inherent limitations over which an auditor has no control from those constraints on the control the auditor exercises over audit inputs and the audit process. In particular, mention should be made of the limitations on auditor access to information and the timing and cost/benefit considerations that drive the audit process, as well as the inherent limitations on the accounting assertions and the related available evidence arising from the application of the requirements of the applicable financial reporting framework to the transactions and other events, and circumstances or conditions, of the entity, and the effect of this application.

206. Because the degree to which the inherent limitations can be identified, assessed and mitigated by the auditor is more limited for some issues and related risks than others, for those audit issues where specific inherent limitations are of particular importance (fraud, related parties and accounting estimates, for example), the introduction section of the relevant ISA ought to include a short treatment of these inherent limitations.

207. The exposure draft of ISA 200 issued in April 2007 proposes to improve the treatment of inherent limitations of an audit in that standard. In particular, mention is made of the limitations on auditor access to information[65], of the timing and cost/benefit considerations that drive the audit process[66], and of the inherent limitations on the accounting assertions and the related available evidence arising from the application of the requirements of the applicable financial reporting framework to the circumstances of the entity[67]. FEE has commented on the exposure draft to the IAASB that the proposed ISA 200 represents a significant improvement over the current ISA 200. FEE recommended to the IAASB that some further limited improvements be made before the draft is finalised. FEE might have recommended more extensive changes to the proposed ISA 200 in light of the analysis in this Paper, but chose not to in the interests of not hindering the scheduling for the Clarity Project and of brevity.

208. Based upon the analysis in this Paper, if the IAASB were disposed to to carry out more extensive revision of ISA 200 at some time in the future, i.e., after the current exposure draft if finalised, there may be additional matters that the IAASB may wish to consider. In particular, it may be useful to draw a distinction between general and specific inherent limitations, and to include a discussion as to why a comprehensive list of specific inherent limitations cannot be developed. The proposed changes to ISA 200 do discuss three general categories of sources of inherent limitations[68], but consideration could be given to providing a treatment of inherent limitations as audit impacts. A discussion covering the degree of control that auditors exercise over the sources of these limitations may also be useful. A systematic treatment of specific inherent limitations may also be of benefit for particular audit areas or issues covered in particular standards (other than just fraud and related parties) in which specific inherent limitations are particularly severe: such a treatment may serve to place the requirements of those standards into context.

209. The focus within the treatment proposed by the exposure draft also continues to appear to be directed towards using the inherent limitations of an audit to explain the difference between reasonable and absolute assurance (without drawing the consequences for the meaning of the use of the word “high” in relation to the word “assurance”), rather than using a treatment of inherent limitations to aid an understanding of the meaning of reasonable assurance by explaining the differences between the absolute, available, obtainable and reasonable assurance (i.e., that reasonable assurance represent a high level of assurance subject to the inherent limitations of an audit).

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[65] IFAC, IAASB Exposure Draft ISA 200.A34, April 2007.

[66] IFAC, IAASB Exposure Draft ISA 200.A38-.A40, April 2007.

[67] International Federation of Accountants, IAASB, Exposure Draft ISA 200.A32, April 2007.

[68] IFAC IAASB, Exposure Draft ISA 200.A28, April 2007.

210. In future, consideration could also be given to improving the categorisation into the three sources as proposed in the exposure draft to better describe and delineate (i.e., avoid overlap) such sources. In particular:

- The first category (fundamental nature of and characteristics of financial reporting and business processes) could delineate sources from activities. Financial reporting is an activity involving both the application of the financial reporting framework to entity circumstances and activities, and the process by which that information is collected and communicated to users. The sources of inherent limitations in this case are actually the requirements and guidance within the financial reporting framework and entity activities and circumstances – not financial reporting generally. It is the application of the framework to the entity circumstances and activities that generates the required financial reporting assertions and the nature and extent of the evidence available and accounting processes required (including the fact that judgment may be necessary). There is also a question as to whether the inherent limitations over the communication aspect of financial reporting can be construed as inherent limitations of an audit. Consideration could also be given to broadening the reference to business processes because there are entity circumstances and activities that have an impact on the application of the financial reporting framework that are not business processes;
- The second category (the nature of audit evidence and procedures) could distinguish between omniscience, available evidence, obtainable evidence, and sufficient appropriate audit evidence; and
- The last category (the need for the audit to be conducted within a reasonable period of time and at reasonable cost) could recognise that in situations where substantive audit procedures may suffice, auditors may, for cost/benefit or timing reasons, choose to rely on internal control. Furthermore, cost/benefit and timing considerations are the reason why, when obtaining sufficient appropriate audit evidence, an auditor does not obtain all of the evidence obtainable.

5.9. *The Main Conclusions Drawn in this Section*

211. The main conclusions drawn in this Section include:

- In an ideal world, users of audits would desire from auditors a guarantee for everything associated with the entity right away at no cost. What users may desire in an ideal world falls short of what audits can deliver in the real world due to the inherent limitations of an audit;
- The inherent limitations of an audit primarily arise from limitations imposed by the financial reporting supply chain and relate to resource allocation decisions, based on relative costs and benefits, that society makes: hence inherent limitations of an audit are not separable from the role of audits in the financial reporting supply chain. The Paper applies the concept of the financial reporting supply chain in its further analysis of the inherent limitations of an audit and develops a categorisation of inherent limitations based upon this perspective;
- General inherent limitations are those inherent limitations that are pervasive to an audit and affect many different financial statement assertions, kinds of assertions or audit issues. Specific inherent limitations reflect the manifestation of general inherent limitations for specific assertions, kinds of assertions or audit issues;
- It is not possible to draw up an exhaustive list of specific inherent limitations of an audit because such a list would literally be endless. However, it is possible to develop a comprehensive categorisation of general inherent limitations;
- There are two basic ways to categorise general inherent limitations of an audit: by control and source, or by audit impact, each of which has advantages and disadvantages. This Paper concentrates on the categorisation by control and source because FEE believes that this categorisation is of greater interest to audit regulators. The categorisation by ***control and source*** is as follows:

  a) General inherent limitations of an audit arising from matters not under the direct control of the auditor
     (i) General inherent limitations arising from the environment surrounding audits and arising from the inputs to the audit process from parts of the financial reporting supply chain other than audits
       - Legal, regulatory or auditing standards requirements defining audit coverage or scope
       - Applicable financial reporting framework and entity activities and circumstances generating the audit object: financial statement assertions and related available evidence
       - Legal, regulatory and ethical prohibitions on auditor access to information
       - Inherent limitations on internal control when substantive procedures are not enough
       - Other environmental factors affecting, or other inputs to, the audit process, such as other legal or regulatory requirements for audits

     (ii) General inherent limitations arising from the users that use the outputs from the audit process (user decision-making from audit results)

  b) General inherent limitations of an audit arising from constraints on the control exercised by the auditor over audit inputs and the audit process
     (i) General inherent limitations arising from constraints on the inputs brought into the audit process by the auditor

(ii) General inherent limitations arising from constraints on the audit process as conducted by the auditor.

The body of this Section provides further details necessary for a further understanding of each category. From an auditing standards setting perspective – as opposed to the financial reporting supply chain or financial reporting system perspective applied in this Paper – audit coverage or scope (the boundaries delineating what an audit is from what it is not), as well as user decision-making from audit results, are not regarded as inherent limitations of an audit. However, audit coverage or scope represents the basis for the treatment of the other inherent limitations of an audit.

- The general inherent limitations arising from matters not under the control of the auditor are primarily imposed directly by the other parts of the financial reporting supply chain: in certain cases, an auditor can, and may, seek to mitigate these limitations in varying degrees, but cannot eliminate them.
- The general inherent limitations arising from constraints on matters over which the auditor has control arise from economic and timing considerations: the auditor has control over these matters, but acts as executor for the other participants in the financial reporting supply chain in trying to balance the costs and benefits and timing of the audit among the participants. Nevertheless, these constraints arising from cost, benefit and timing considerations represent real constraints and hence inherent limitations on the work of an auditor.
- FEE believes that a more systematic treatment of inherent limitations of an audit could be included in the ISAs. Such a treatment may include:
  - A systematic treatment of general inherent limitations of an audit in ISA 200 that addresses the sources of inherent limitations and the degree of control that an auditor can exercise, or the degree to which an auditor can mitigate, these limitations; in particular, mention should be made of the limitations on auditor access to information and the timing and cost/benefit considerations that drive the audit process, as well as the inherent limitations on the financial statement assertions and the related available audit evidence arising from the application of the financial reporting framework to the transactions and other events, and circumstances or conditions, of the entity;
  - An explanation of the distinction between general and specific inherent limitations and of why a comprehensive list of specific inherent limitations cannot be developed;
  - For those audit issues addressed in particular auditing standards for which specific inherent limitations are of particular importance (e.g., fraud, related parties, accounting estimates, going concern), the relevant ISA ought to include a short treatment of relevant specific inherent limitations.
- The current exposure draft of ISA 200 includes significant improvements over current ISA 200. FEE notes the following matters that may be considered in a future revision of ISA 200:
  - Further delineation of sources and activities;
  - Reduction of the degree of overlap between the categories of sources of inherent limitations;
  - Additional guidance on how the categories lead to different evidence concepts that explain the meaning of sufficient appropriate audit evidence.

SECTION 6. THE RELATIONSHIP BETWEEN INHERENT LIMITATIONS AND OTHER CONCEPTS

6.1. Purpose of this Section

212. The purpose of the Section is to explore the relationship between the inherent limitations of an audit and certain central auditing concepts, including:
    - Audit evidence and scope limitations,
    - Audit risk, and
    - Reasonable assurance.

213. In particular, this Section examines the impact of the inherent limitations of an audit on these concepts and explains these concepts.

6.2. Inherent Limitations, Audit Evidence and Scope Limitations

6.2.1. Audit Evidence

214. The question of audit evidence is central to the issue of the comfort (the degree of certainty that the audit opinion is appropriate) that an auditor can obtain and considers necessary to obtain in relation to whether the financial statements are prepared and presented in accordance with the applicable financial reporting framework. It is the inherent limitations of an audit that determine what, and how much, evidence and hence the comfort that can be obtained, and that an auditor considers necessary to obtain. Paragraphs 160 to 163, and paragraphs 164 and 166, address the issue of evidence based upon the treatment of evidence in the FEE Issues Paper "Principles of Assurance"[69]. As noted, the available evidence refers to the evidence that is generated by applying the requirements of the applicable financial reporting framework to the transactions and other events, and circumstances or conditions, of the entity: it represents the evidence that would be theoretically obtainable by the auditor without any limitations on access to information. However, because of other inherent limitations leading to the lack of *absolutely conclusive* available evidence, the available evidence is less than omniscience, which would include the ability to predict the future.

215. As noted in paragraph 112, inherent risks are greater for some assertions and related classes of transactions, account balances, and disclosures than for others. The inherent risks for different assertions differ in part because the evidence available (nature, extent and strength) to support different assertions differs by assertion. Furthermore, as noted in paragraph 113, controls are more effective in responding to some kinds of inherent risks than others. Consequently, the controls applied by management to respond to inherent risks also vary. This implies that control risk varies by assertion. Since the controls applied to respond to inherent risks and the effectiveness of controls vary by assertion, there is a strong case that available evidence supporting assessments of control risk and the effectiveness of controls also varies by assertion. As a result, the audit evidence available to support an assessment of the risks of material misstatement varies by assertion. Hence, irrespective of the audit process, due to the inherent limitations of financial statements, the audit evidence available to support different assertions varies.

[69] For a treatment of the relationship between subject matter, criteria and assertions on the one hand, and evidence on the other hand, see the FEE Issues Paper "Principles of Assurance: Fundamental Theoretical Issues With Respect to Assurance in Assurance Engagements" (FEE: Brussels, April 2003), pp. 231-256.

216. However, as noted in paragraph 165, there are inherent limitations beyond the control of the auditor on the audit process – in particular, in relation to the limitations on the evidence that an auditor is able to obtain in relation to the available evidence. Hence, there is a difference between available evidence and the evidence actually obtainable by the auditor (obtainable evidence). Since access to evidence by the auditor varies by assertion, so too does the obtainable evidence in relation to the available evidence. Given the variation in available evidence by assertion and the variation in obtainable evidence in relation to available evidence by assertion, then the absolute variation in obtainable evidence (nature, extent and strength) for different assertions is considerable.

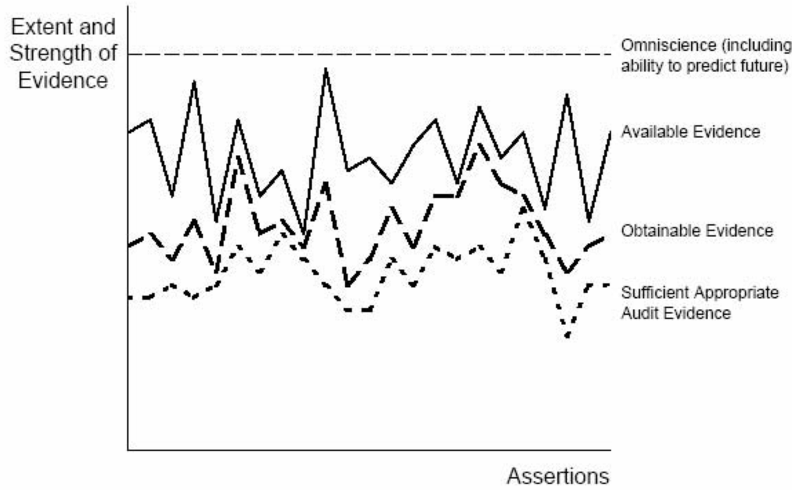
217. Auditing standards implicitly distinguish between obtainable audit evidence and the audit evidence that an auditor considers necessary to obtain, which is referred to as "sufficient appropriate audit evidence". The adjective "sufficient" is generally taken to refer to the quantity of evidence, whereas the adjective "appropriate" refers to the quality of evidence. However, it is not clear in this case how the concept of "sufficient appropriate audit evidence" covers the "strength" of the evidence.

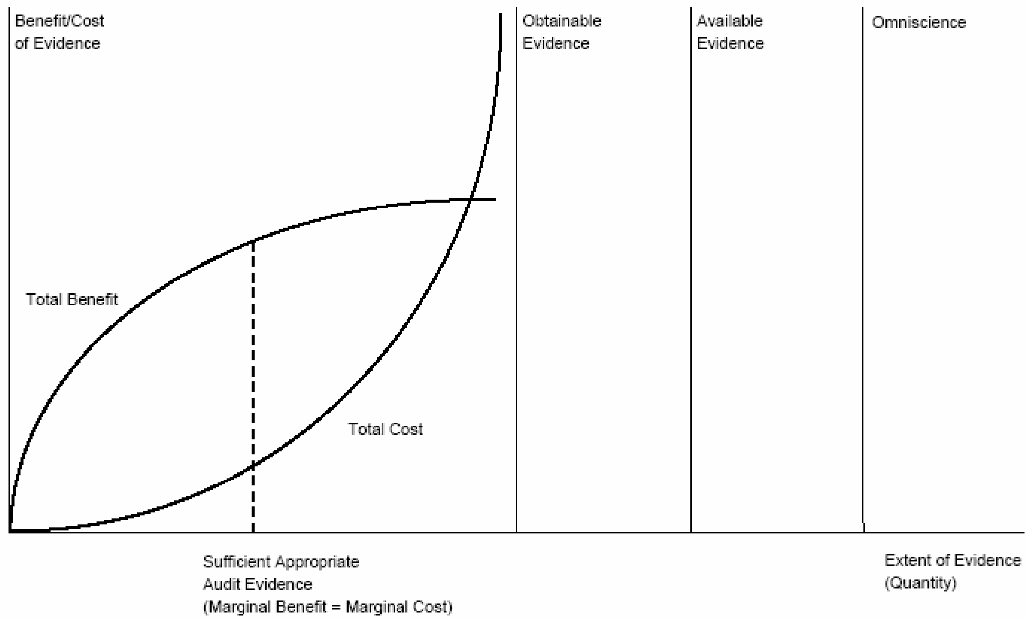
218. Pursuant to the exposure draft of ISA 500, evidence is "appropriate" if it pertains to the matter at hand (its nature: i.e., is it "relevant", or "does it have the appropriate nature") and is "reliable". The concept of "relevance" is binary: either evidence is relevant or it is not. It is unclear from the exposure draft what "reliability" actually means in relation to these concepts[70]. In particular, if sufficiency refers only to the physical "quantity" of evidence (extent) and relevance to its pertinence (nature), it is unclear how the "strength" of the evidence is addressed (reliability?). In particular, the degree to which evidence is adequate is not only a function of its quantity (extent: how much) and pertinence (nature: what kind), but also of its evidential value (strength: how good). Consequently when speaking of obtainable evidence relative to the evidence that is, or that an auditor considers ought to be, obtained, all three aspects (nature, extent and strength) are applicable.

219. Paragraphs 183 to 185 address inherent limitations on the audit process arising from cost/benefit and timing considerations over which the auditor has influence. These inherent limitations, particularly the fact that the benefit of obtaining additional audit evidence is subject to diminishing returns and the marginal net benefit of obtaining additional evidence declines and, at some point the marginal cost actually exceeds the marginal benefit, means that auditors should not and do not obtain all of the evidence obtainable. This is true regardless of the decision model applied by the auditor.

220. The implication of these matters is clear: due to the inherent limitations of an audit, the evidence obtained (sufficient appropriate audit evidence) relative to that obtainable varies by assertion. Accordingly, given the considerable variation in evidence obtainable for different assertions, the cumulative variation in evidence obtained by the auditor varies substantially by assertion. However, although available, obtainable, and sufficient appropriate audit evidence each vary by assertion, there is a loose correlation among them. The diagrams below depict some of the interrelationships between the evidence concepts discussed in this Section. They are for illustrative purposes only, do not necessarily reflect all possible relationships among the concepts, and are not drawn to scale.

[70] International Federation of Accountants (IFAC), International Auditing and Assurance Standards Board (IAASB), Exposure Draft ISA 500 "Considering the Relevance and Reliability of Audit Evidence", (IFAC: New York, April 2007), paragraphs10 (d) and .A21-.A27.


The Relationship Among Evidence Concepts
by Assertion
Extent and
Strength of
Evidence
Omniscience (including
ability to predict future)
Available Evidence
Obtainable Evidence
Sufficient Appropriate
Audit Evidence
Assertions
For illustrative purposes only: not drawn to scale


Sufficient Appropriate Audit Evidence for an Assertion and
Diminishing Returns for Additional Evidence
Benefit/Cost
of Evidence
Obtainable
Evidence
Available
Evidence
Omniscience
Total Benefit
Total Cost
Sufficient Appropriate
Audit Evidence
(Marginal Benefit = Marginal Cost)
Extent of Evidence
(Quantity)
For illustrative purposes only: not drawn to scale

6.2.2. *Scope Limitations*

221. One of the matters that arises when analysing inherent limitations of an audit and the impact of such inherent limitations on audit evidence is the delineation between inherent limitations and scope limitations (which relate to the inability to get sufficient appropriate audit evidence). Scope limitations that cannot be overcome by the auditor through alternative audit procedures lead to a qualification of opinion or a disclaimer of opinion.

222. ISA 200.10 defines the "scope of an audit" as "the audit procedures that, in the auditor's judgment and based on the ISAs, are deemed appropriate in the circumstances to achieve the objective of the audit"[71]. ISA 701.16 and .17 define a "limitation on scope" as follows:

"A limitation on the scope of the auditor's work may sometimes be imposed by the entity (for example, when the terms of the engagement specify that the auditor will not carry out an audit procedure that the auditor believes is necessary)…

A scope limitation may be imposed by circumstances (for example, when the timing of the auditor's appointment is such that the auditor is unable to observe the counting of physical inventories). It may also arise when, in the opinion of the auditor, the entity's accounting records are inadequate or when the auditor is unable to carry out an audit procedure believed to be desirable[72]."

223. Since audit procedures yield audit evidence, scope limitations can also be defined in terms of the inability of the auditor to obtain sufficient appropriate audit evidence due to management restrictions or other circumstances. ISA 701.17 goes on to explain that in these circumstances, the auditor would attempt to perform alternative audit procedures to obtain sufficient appropriate audit evidence to support an unqualified audit opinion[73].

224. The new proposed Exposure Draft ISA 705 (Revised) "Modifications to the Opinion in the Independent Auditor's Report" does not apply the concept of scope limitations, but rather speaks of the inability of the auditor to obtain sufficient appropriate audit evidence to conclude that the financial statements are free of material misstatement, the consequence of which is a modified opinion[74] (qualified opinion or disclaimer of opinion)[75]. Although this is an approach based on evidence rather than procedures, such an inability is effectively the same as a scope limitation. Consequently, this Paper will refer to the inability of the auditor to obtain sufficient appropriate audit evidence to conclude that the financial statements are free of material misstatement as a scope limitation.

225. If one takes the inherent limitation as an impact on the audit perspective (see paragraph 144), what is not clear about a scope limitation in this respect, is the distinction between an inherent limitation on the audit opinion as described in paragraph 187 compared to a scope limitation. In particular, the distinction between general limitations on the nature, timing and strength of the audit opinion or the general inherent limitations on the form and content of communication of the audit opinion, on the one hand, and a scope limitation on the other hand, requires further examination because clearly, not all such general inherent limitations lead to scope limitations. If all such inherent limitations were to lead to scope limitations, then there would be a proliferation of qualified and disclaimers of opinion because these inherent limitations are common to all audits: this is clearly not desirable.

226. For example, when an auditor seeks an external confirmation from a third party to obtain sufficient appropriate audit evidence, the external party may refuse to provide the auditor

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71 IFAC, IAASB ISA 200.10, 2007.

72 IFAC, IAASB ISA 701 "Modifications to the Independent Auditor's Report" 2007, paragraphs 16-17.

73 IFAC, IAASB ISA 701.17, 2007.

74 International Federation of Accountants (IFAC), International Auditing and Assurance Standards Board (IAASB) Exposure Draft ISA 705 (Revised) "Modifications to the Opinion in the Independent Auditor's Report", July 2007, paragraph 9 (b).

75 IFAC, IAASB Exposure Draft ISA 705 (Revised) , July 2007, paragraphs 10 (b) and 12.

with the needed confirmation. Nevertheless, if the auditor cannot obtain sufficient appropriate audit evidence by alternative audit procedures and the auditor determines that the confirmation is necessary to obtain sufficient appropriate audit evidence, then the inability to obtain that confirmation constitutes a scope limitation. Moreover, this scope limitation is caused by an inherent limitation of an audit: an auditor's limited access to information resulting from legal limitations on auditor powers to extract such confirmations from third parties. Consequently, scope limitations *do* result from inherent limitations of an audit.

227. However, as noted previously, not all inherent limitations of an audit result in scope limitations. The question then arises why some inherent limitations lead to scope limitations when others do not. The distinction appears to arise from the difference in effect on audit evidence based upon the defining characteristic of a scope limitation: the inability to obtain sufficient appropriate audit evidence. This means that inherent limitations that do not lead to scope limitations are those where the auditor is able to obtain sufficient appropriate audit evidence (i.e., the auditor is able to obtain the evidence the auditor considers necessary to obtain relative to that obtainable), whereas inherent limitations lead to scope limitations where an auditor is unable to obtain sufficient appropriate audit evidence.

228. Hence, the distinction turns on the definition of what sufficient appropriate audit evidence is. Generally speaking, if audit evidence is not ordinarily obtainable, it should not ordinarily need to be obtained (i.e., inherent limitations ordinarily common to all audits should not generally cause scope limitations). This suggests that, obversely, one potential source of scope limitations results from circumstances in which an auditor cannot obtain the evidence ordinarily obtainable that the auditor considers needs to be obtained.

229. Although an inherent limitation caused by evidence ordinarily unobtainable is ordinarily common to all audits, in certain circumstances, such unobtainable evidence nevertheless leads to a scope limitation. Such exceptional circumstances arise where some evidence obtained casts doubt on other evidence obtained, which means that the auditor may need further ordinarily unobtainable evidence to resolve this matter. While this circumstance may be exceptional, it appears that, if a matter cannot be resolved to the auditor's satisfaction without such ordinarily unobtainable evidence, then an auditor would conclude that a scope limitation exists.

230. The question also arises whether it matters if an inherent limitation arises from matters beyond the control of the auditor or from constraints (e.g., time and cost/benefit constraints) on matters over which the auditor has control. If evidence is ordinarily unobtainable due to matters beyond the control of the auditor, then clearly such inherent limitations would not generally constitute a scope limitation (except in the exceptional circumstances mentioned above). On the other hand, if evidence is ordinarily not available due to timing or cost/benefit constraints, the inherent limitations are not any less real, nor does this change the obtainable evidence or the evidence that needs to be obtained relative to that obtainable. Consequently, what sufficient appropriate audit evidence is, is not affected by the nature of the category of the inherent limitation.

231. These are abstract concepts, but they appear to be less subjective and hence an improvement over the current criteria for a scope limitation, which provide no guidance on the issue and could lead to regulators demanding more qualifications or disclaimers of opinion than is currently the case. In conclusion, a scope limitation would occur when the audit evidence that can be obtained by the auditor is less than that which needs to be obtained given that ordinarily obtainable, or in exceptional circumstances, when a matter cannot be resolved to the auditor's satisfaction without ordinarily unobtainable evidence. While all scope limitations result from inherent limitations, not all inherent limitations (the ones common to all audits) result in scope limitations.

6.3. *Inherent Limitations, Audit Risk and Reasonable Assurance*

6.3.1. *Audit Risk*

232. The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated is referred to as "audit risk"[76]. Audit risk is an expression of the comfort that an auditor has not obtained through the audit that the audit opinion is the right one, but this definition does not include the risk that the auditor might erroneously express an opinion that the financial statements are materially misstated[77].

233. Audit risk is a function of the assessed risk of material misstatement (see a discussion of risks of material misstatement in Section 4.2.5 and the auditor's assessment thereof in paragraph 125) and detection risk, which represents the risk that the auditor does not detect such material misstatements in the financial statements through the audit. Since misstatement risk and detection risk, and hence audit risk, relate to the *likelihood of occurrence* of a material misstatement in the financial statements, there is a probabilistic relationship between these that is often expressed in Bayesian terms to aid theoretical understanding (and prevent additive application of risks in practice – not to provide a precise numerical analysis of risk) as follows: audit risk = misstatement risk x detection risk. However, this formula applies only if misstatement and detection risk are completely independent of one another, which, as noted in paragraph 236 below, is often not the case. This greatly complicates the mathematics involved. Furthermore, an actual, objective determination of numerical values for these is not possible in practice: this implies the need for the application of professional judgment by the auditor.

234. Since misstatement risk is beyond the control of the auditor, to reduce audit risk to a desired level, the auditor must reduce detection risk accordingly. Hence, for a given desired level of audit risk, the greater the level of assessed misstatement risk, the more the auditor must reduce detection risk. Consequently, an audit is directed towards mitigating that risk by reducing detection risk. Auditors reduce detection risk by performing audit procedures to obtain audit evidence in response to misstatement risks. Detection risk is a function of the effectiveness of an audit procedure and of its application by the auditor[78] in obtaining audit evidence.

235. However, the reduction in detection risk is subject to the inherent limitations of an audit (in particular, when taking inherent limitations as an impact on the audit perspective, the inherent limitations on the audit opinion). Consequently, detection risk is subject to the inherent limitations of an audit associated with the financial statements assertions and related evidence, as well as those limitations associated with the audit process. As noted in various parts of Section 50, the inherent limitations associated with the financial statement assertions and related evidence are beyond the control of the auditor, as are some of the inherent limitations associated with the audit process. Subject to the inherent limitations of an audit, all other things being equal, more audit evidence supporting the lack of a material misstatement in the financial statements implies lower detection risk and hence audit risk.

236. The inherent limitations of an audit imply not only that detection risk, and hence audit risk, cannot be reduced to zero, but also given the variations in the audit evidence that an auditor needs to obtain to gain sufficient appropriate audit evidence (see paragraphs 217 to 220), it implies that the desired level of detection risk, and hence the desired level of audit risk, vary substantially by assertion. This is exacerbated by the fact that detection risk is not completely independent of the risk of material misstatement because, just as controls are often less

[76] IFAC, IAASB ISA 200.23, 2007.
[77] IFAC, IAASB ISA 200.23, footnote 4, 2007.
[78] IFAC, IAASB ISA 200.31, 2007.

effective in responding to certain inherent risks (see paragraph 113) than others, so too, often audit procedures performed to assess such risks and in response to assessed risks of material misstatement may also be less effective in assessing, or responding to, certain inherent and control risks.

237. When an auditor has obtained sufficient appropriate audit evidence to support the audit opinion, by definition, audit risk is reduced to an acceptably low level[79], which then achieves the objective of the audit (other than communication of the audit findings). However, since the audit evidence that is sufficient and appropriate varies by assertion, so too the level of audit risk that is acceptably low varies by assertion. This is the reason for the use of the adjective "acceptably" to modify the expression low risk, for a uniform low level of audit risk is not achievable due to the inherent limitations of an audit. Furthermore, to the extent that audit risks for particular assertions are independent of one another, the lowest level of audit risk that can be achieved for the audit of financial statements as a whole cannot be less than that for the assertion with the greatest level of audit risk.

238. An auditor applies considerable professional skill and judgment to reduce audit risk to an acceptably low level by accordingly reducing detection risk through the acquisition of audit evidence. Overall, these matters signify that there are inherent limitations on an auditor's ability to properly identify and assess risks of material misstatement. In addition, although auditors respond to all risks of material misstatement assessed as being greater than at an acceptably low level, the effectiveness of the responses available to, and hence performed by the auditor, to address those assessed risks varies due to the inherent limitations of an audit described in Section 5.5.

6.3.2. Reasonable Assurance

239. Reasonable assurance is the expression used by auditors to describe the level of confidence or comfort required by an auditor to enable the expression of an audit opinion: it defines the "strength" of that opinion. By definition, reasonable assurance has been achieved when the auditor has obtained sufficient appropriate audit evidence and hence reduced audit risk to an acceptably low level[80]. Hence, there is an inverse relationship between audit risk and audit assurance, but not necessarily one that can be described using parametric mathematical methods. Consequently, subject to the inherent limitations of an audit, and all other things being equal, more audit evidence implies greater assurance.

240. The term "reasonable assurance" essentially expresses the appropriate level of assurance that a prudent auditor ought to obtain given the inherent limitations of an audit. This is the reason for the appellation "reasonable". However, given the inherent limitations of an audit and the variation in audit risk that is acceptable by assertion, not only can absolute (100 %) assurance not be achieved in an audit, but what reasonable assurance is varies by assertion. This means that what reasonable assurance signifies in particular circumstances is context-driven, which suggests that the use of the adjective "reasonable" to describe the level of assurance that should be obtained is indeed apt. Furthermore, to the extent that the levels of assurance achieved for different assertions are independent of one another, the highest level of assurance that can be achieved for the financial statements as a whole cannot be greater than that for the assertion for which the lowest level of assurance was obtained. Given the meaning of materiality for the financial statements as a whole (see Section 4.2.3), this implies that reasonable assurance for an assertion in relation to the financial statements as a whole (e.g., going concern, or whether the financial statements give a true and fair view, or

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[79] IFAC, IAASB ISA 200.24, 2007.

[80] IFAC, IAASB ISA 200.24, 2007.

fairly present, in all material respects) would not be greater than that for assertions for specific items in the financial statements.

241. Due to the inherent limitations on the audit process arising from cost/benefit and timing considerations representing constraints on matters over which the auditor has control, additional assurance is subject to diminishing returns and the marginal net benefit of obtaining additional evidence declines and, at some point the marginal cost actually exceeds the marginal benefit, which means that auditors should not and do not obtain all of the assurance obtainable. When the assurance that has been achieved is reasonable (i.e., the marginal benefits are equal to the marginal costs), is a matter requiring professional judgment of the auditor (see Section 7.8).

242. The assurance concepts parallel the evidence concepts described in Section 6.2.1 (and therefore are independent of the decision model applied by the auditor). Consequently, the level of assurance that an auditor considers necessary (reasonable assurance) is less than the assurance that an auditor can obtain (obtainable assurance), which in turn is less than the assurance available if there were, for example, no limitations on auditor access to information. Consequently, due to the inherent limitations of an audit beyond an auditor's control, which lead to differences in the assurance obtainable for different assertions, it is not possible for auditors to perform additional audit procedures to identify and assess, and hence mitigate, misstatement risks to obtain a level of assurance that is always the same relative to absolute assurance. Furthermore, even if auditors were able to do so, it would not be desirable because in most circumstances the costs of performing additional procedures would exceed the benefits.

243. The fact that the reasonable assurance is context-driven and hence may mean reasonable assurance reflects different levels of assurance relative to absolute among different assertions within a set of financial statements and between different sets of financial statements, does not mean that audit work on different assertions within the financial statements, or audits of different financial statements, are inconsistent or not comparable. The expertise obtained by auditors through common forms of education and training enable experienced auditors to exercise reasonable judgement in determining when the costs of additional audit work may exceed the benefits in a broadly consistent manner in similar circumstances. However, this does not mean that the reasonable judgement of one auditor in this respect will always be the precisely same as that of another in any particular circumstance (see Section 7.8). It does mean that the relative costs vs. benefits of the reasonable assurance obtained would be equivalent. For this reason, it is not a problem that audit reports remain the same in different situations.

244. For virtually all assertions in accrual financial statements, the assurance available is less than absolute assurance because accrual financial statements always require estimations of the future outcomes of events (e.g., estimated remaining useful life of assets, or impairment of recoverable amounts below cost, the going concern assumption, etc.) and the outcome of future events always involves uncertainty that cannot be eliminated. Naturally, the greater the degree to which financial reporting frameworks include information based on future-oriented information, or information based on the prediction of future events (e.g. fair values of items for which no active market exists), the greater the difference between the available assurance and absolute assurance.

245. Some standards setters and some auditing literature describe reasonable assurance as being a "high" level of assurance. This is true – subject to the inherent limitations of an audit. In other words, given the difference between the audit evidence that auditors consider necessary to obtain relative to that obtainable by assertion, auditors obtain a high level of audit evidence relative to that obtainable for particular assertions. So too, auditors obtain a high level of assurance relative to that obtainable by assertion, but not relative to absolute (100 %)

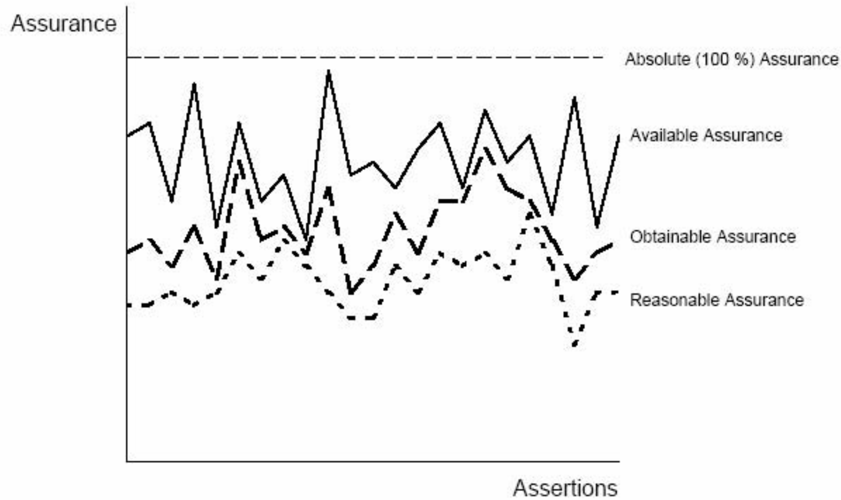
assurance for the financial statements as a whole. What would be misleading would be to describe reasonable assurance as being a high level of assurance without qualifying that this high level is relative because it is subject to the inherent limitations of audit.

246. It is important for auditing standards setters and the auditing profession to address the inversion in the expectation gap (i.e, unrealistic expectations in relation to audits caused by readers interpreting auditing standards as suggesting that audits can achieve more than they actually can, such as users interpreting the auditing standards as requiring the achievement of a uniform high level of assurance relative to absolute (100 %) assurance for every assertion in the financial statements and hence for the financial statements as a whole). Consequently, given the inherent limitations of an audit, it is important that the use of the term “high assurance” be appropriately qualified to convey the fact that “high” is being used as a relative term (i.e., high assurance in relation to obtainable assurance, as opposed to absolute assurance) by adding such words as “subject to the inherent limitations of an audit” to any use of the term “high assurance” (e.g., “reasonable assurance is a high level of assurance subject to the inherent limitations of an audit”).

247. The concepts addressed in this Section, and in particular, the concept of reasonable assurance dealt with in this Subsection, are difficult for lay users of audit reports to understand. However, the fact that these concepts are difficult does not mean that there is a simpler conceptual replacement in sight that could solve this understandability problem. Rather, it appears to be important that these concepts be adequately explained in auditing standards.

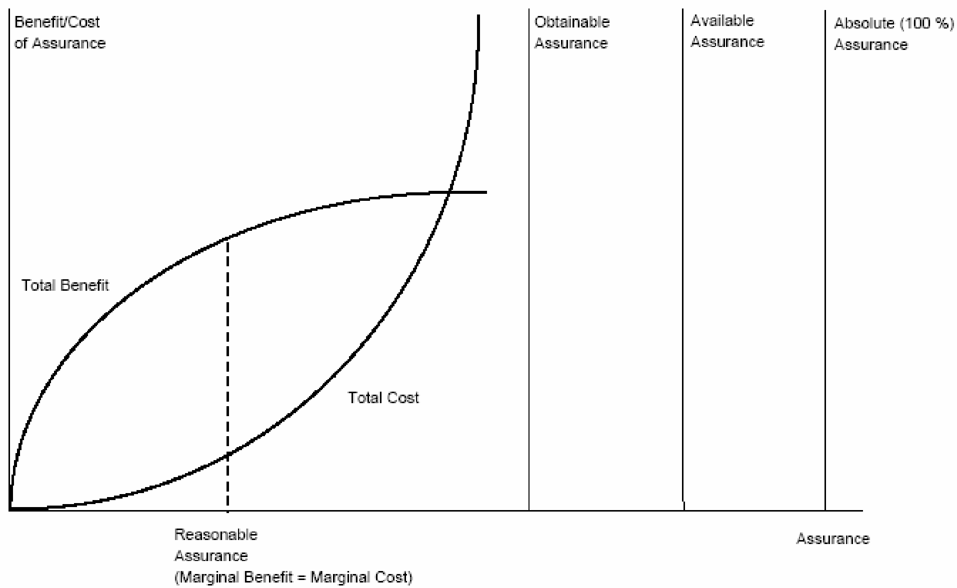
248. The diagrams below depict some of the interrelationships between assurance concepts. The diagrams are for illustrative purposes only, do not necessarily reflect all possible relationships among the concepts, and are not drawn to scale.

The Relationship Between Reasonable and Absolute Assurance by Assertion



For illustrative purposes only: not drawn to scale

Diminishing Returns for Reasonable Assurance for a Particular Assertion



For illustrative purposes only: not drawn to scale

6.4. The Main Conclusions Drawn in this Section

249. The main conclusions drawn in this Section include:

- It is the inherent limitations of an audit that determine what, and how much, evidence, and hence the comfort, that can and needs to be obtained by an auditor: consequently, the inherent limitations of an audit have a direct impact on the meaning of sufficient appropriate audit evidence, acceptably low level of audit risk, and reasonable assurance;
- Auditing standards implicitly distinguish between obtainable audit evidence and the audit evidence that an auditor considers necessary to obtain, which is referred to as "sufficient appropriate audit evidence". Due to the inherent limitations (constraints) on the audit process arising from cost/benefit and timing considerations, the net benefit of obtaining additional audit evidence towards obtainable evidence is subject to diminishing returns (the marginal net benefit of obtaining additional evidence declines and, at some point the marginal cost actually exceeds the marginal benefit), which means that auditors should not and do not obtain all of the evidence obtainable;
- Auditors seek to mitigate the risk of material misstatement ("misstatement risk") in the financial statements by reducing detection risk. The inherent limitations of an audit imply not only that detection risk, and hence audit risk, cannot be reduced to zero, but also given the variations in the audit evidence that an auditor considers necessary to obtain to gain sufficient appropriate audit evidence for particular assertions, detection, and hence audit risk, vary substantially by assertion. This is exacerbated by the fact that detection risk is not completely independent of the risk of material misstatement because, just as controls are often less effective in responding to certain inherent risks than others, so too, often audit procedures performed to assess such risks and respond to assessed risks of material misstatement may also often be less effective in assessing, or responding to, certain inherent and control risks;
- Since the audit evidence that is sufficient and appropriate varies by assertion, so the level of audit risk that is acceptably low varies by assertion. Furthermore, to the extent that audit risks for particular assertions are independent of one another, the lowest level of audit risk that can be achieved for the audit of financial statements as a whole cannot be less than that for the assertion with the greatest level of audit risk. Overall, these matters signify that there are inherent limitations on an auditor's ability to properly identify and assess risks of material misstatement. In addition, although auditors respond to all risks of material misstatement assessed as being greater than at an acceptably low level, the effectiveness of the responses available to, and hence performed by, an auditor, to address those assessed risks varies;
- Given the inherent limitations of an audit and the variation in audit risk that is acceptable by assertion, not only can absolute (100 %) assurance not be achieved in an audit, but what reasonable assurance is varies by assertion. Furthermore, to the extent that the levels of assurance achieved for different assertions are independent of one another, the highest level of assurance that can be achieved for the financial statements as a whole cannot be greater than that for the assertion for which the lowest level of assurance was obtained. Due to the inherent limitations (constraints) on the audit process arising from cost/benefit and timing considerations, the net benefit of obtaining additional assurance is subject to diminishing returns (the marginal net benefit of obtaining additional evidence declines and, at some point the marginal cost actually exceeds the marginal benefit), which means that auditors

should not and do not obtain all of the assurance obtainable;

- Due to the inherent limitations of an audit beyond an auditor's control, which lead to differences in the assurance obtainable for different assertions, it is not possible for auditors to perform additional audit procedures to identify and assess, and hence mitigate, misstatement risks to obtain a level of assurance that is always the same relative to absolute assurance. Furthermore, even if auditors were able to do so, it would not be desirable because in most circumstances the costs of performing additional procedures would exceed the benefits;
- The fact that the reasonable assurance is context-driven and hence may mean reasonable assurance reflects different levels of assurance relative to absolute among different assertions within a set of financial statements and between different sets of financial statements, does not mean that audit work on different assertions within the financial statements, or audits of different financial statements, are inconsistent or not comparable. The expertise obtained by auditors through common forms of education and training enable experienced auditors to exercise reasonable judgement in determining when the costs of additional audit work may exceed the benefits in a broadly consistent manner in similar circumstances. However, this does not mean that the reasonable judgement of one auditor in this respect will always be the precisely same as that of another in any particular circumstance. It does mean that the relative costs vs. benefits of the reasonable assurance obtained would be equivalent. For this reason, it is not a problem that audit reports remain the same in different situations;
- It is important for auditing standards setters and the auditing profession to address unrealistic expectations in relation to audits caused by readers interpreting auditing standards as suggesting that audits can achieve more than they actually, such as users interpreting the auditing standards as requiring the achievement of a uniform high level of assurance relative to absolute (100 %) assurance for every assertion in the financial statements and hence for the financial statements as a whole. Consequently, given the inherent limitations of an audit, it is important that the use of the term "high assurance" be appropriately qualified to convey the fact that "high" is being used as a relative term (i.e., high assurance in relation to obtainable assurance, as opposed to absolute assurance) by adding such words as "subject to the inherent limitations of an audit" to any use of the term "high assurance" (e.g., "reasonable assurance is a high level of assurance subject to the inherent limitations of an audit"); and
- The concepts addressed in this Section, and in particular, the concept of reasonable assurance, are difficult for lay users of audit reports to understand. However, the fact that these concepts are difficult does not mean that there is a simpler conceptual replacement in sight that could solve this understandability problem. Rather, it appears to be important that these concepts be adequately explained in auditing standards.

SECTION 7. INHERENT LIMITATIONS, EXPERTISE, JUDGMENT AND STANDARDS

7.1. *Purpose of this Section*

250. The purpose of the Section is to explore the relationship between inherent limitations of an audit, the need for professional judgment, and professional standards. This Section explains these concepts and examines:

- The exercise of professional judgment when applying auditing standards;
- Why, when and how professional judgment ought to be exercised;
- The documentation of professional judgment; and
- The treatment of professional judgment in the ISAs and the relationship between reasonable assurance and the exercise of professional judgment.

7.2. *The Nature of Professional Expertise and Professional Judgment*

7.2.1. *The Nature of Professional Expertise*

251. The word “expert” or “expertise” is commonly associated with the notion of a special skill or knowledge, or skill resulting from training or experience[81]. Indeed the use of the term “expert” or “expertise” “…suggests an extraordinary proficiency, combining great skill with thorough knowledge”[82]. The word “professional” as an adjective refers to something “…connected with, preparing for, engaging in, appropriate to or conforming to a “profession””, which is usually defined as “…an occupation that properly involves a liberal, scientific or artistic education or its equivalent, and usually mental rather than manual labour”[83]. Hence professional expertise in relation to the exercise of a profession would refer to extraordinary proficiency, combining great skill with thorough knowledge obtained from training and experience, exercised in conformity with a professional occupation that properly involves a liberal, scientific or artistic education or its equivalent. This definition encompasses some of the basic elements necessary for professional expertise that represent that context for its application:

- A high level of liberal, scientific or artistic education (at a theoretical level);
- Training so that education can be used with great skill in practice;
- Experience so that the education and training can be applied with extraordinary proficiency;
- Continuing professional development to maintain professional expertise; and
- Exercise of professional expertise in conformity with a professional occupation, which implies the existence of professional ethics, ethos, and standards.

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[81] Adapted from Funk & Wagnalls Canadian College Dictionary, (Fitzhenry & Whiteside Limited, Ontario, Canada, 1989), p. 468.

[82] Adapted from Funk & Wagnalls Canadian College Dictionary, (Fitzhenry & Whiteside Limited, Ontario, Canada, 1989), p. 1258, comparison to word “skilful”.

[83] Funk & Wagnalls Canadian College Dictionary, (Fitzhenry & Whiteside Limited, Ontario, Canada, 1989), pp. 1075 and 1076.

252. As the economist John Kay points out, "genuine expertise comes with knowledge that is not rules-based"[84]. Hence, professional expertise implies competence beyond mere rules-based knowledge, for if knowledge of the rules were all that would be required, professional expertise would not be necessary.

7.2.2. The Nature of Professional Judgment

253. Judgment, and hence professional judgment, is a concept at variance with the pure application of rules[85]. This statement requires an explanation of what a "rule", and what "judgment", is.

254. Generally, rules are thought of as imperatives (a command) requiring an action when certain circumstances apply. A "command" can be defined as a directive compelling a subject (whether an individual, machine or other entity) to perform a certain action (operation) on an object or in relation to objects. An "instruction" represents a form of communicated information that contains a command. However, rules are more than just instructions in this sense: they involve an instruction with a command to perform a certain action *when* certain conditions apply: i.e., they involve a so-called "if-then" conditional, which means that the instruction in the rule becomes relevant when the conditions defined by the rule apply. Sometimes the conditions are explicit and sometimes they are not self-evident: usually they are a combination of both. Care needs to be taken in ascertaining the conditions prompting the applicability of a rule. Hence a rule may be defined as an instruction compelling a subject to perform a certain action when certain conditions apply. An algorithm would represent a finite set of instructions for performing a particular task.

255. "Judgment" has been defined as meaning "estimating outcomes and evaluating consequences of outcomes leading to a decision or choice among alternative actions"[86]. However this definition does not differentiate between a "judgment" as an outcome (i.e., the conclusion) and the "judgment process", nor between the application of "judgment" and other kinds of decision-making, including "guessing". In other words, in that definition judgment is not linked to the application of knowledge, skill, experience or expertise. Furthermore, "consequences" are "outcomes", in the widest sense of the use of the term "outcomes", and judgment would not be necessary if an algorithm could be applied. In attempting to alleviate these weaknesses, a better description of judgment would be the application of knowledge, skill, experience or expertise in decision-making about alternative courses of action when such decision-making is not susceptible to algorithmic resolution when assessing the potential outcomes of those actions.

256. Professional judgment, then, would represent the application of professional expertise in decision-making about alternative courses of action in the exercise of professional activities when such decision-making is not susceptible to algorithmic resolution. Consequently, professional activities that cannot be reduced to an algorithm (e.g., cannot be reduced to mere "ticking the box") require the application of professional judgment. Although the basis for professional activities is a "science", the actual performance of professional activities represents an "art" or "craft". The degree of professional judgment required to be applied depends on the degree to which any applicable professional standards or guidance that prescribe or guide the professional activity of the professional, have algorithmic characteristics, or on the degree to which professional practice or other sources of

[84] John Kay, Financial Times, July 4, 2006.

[85] Canadian Institute of Chartered Accountants (CICA), "Professional Judgement and the Auditor", Research Report (CICA: Toronto, 1995), p. 2.

[86] CICA, 1995, p. 2.

information may be brought to bear on the decision-making process. The less susceptible a professional decision-making process is to algorithmic resolution, the greater the professional judgment required to be applied.

257. The exercise of professional judgment is, however, influenced by the particular expertise of the particular professional and other aspects of the context of its application noted in paragraph 251. Hence, the exercise of professional judgment involves a measure of subjectivity and reflects personal qualities of the professional. However, the training, experience and other measures a professional undertakes to gain and maintain professional expertise are intended to promote consistency of judgment such that the exercise of professional judgment in any particular case may be regarded as reasonable if other experienced professionals can agree that this is the case. Of course, any such agreement on whether the exercise of professional judgment is reasonable is based on the facts and circumstances at the time the judgment was made[87].

258. Overall, the exercise of professional judgment is essential where algorithmic resolution of issues is inapplicable. This includes situations where rules apply, but the application of the rules requires considerable interpretation because either the determination of whether the conditions for when the rules become relevant or the determination of how the action commanded by the rule ought to be carried out in detail may require significant interpretation. Such a need for interpretation represents an inherent limitation on that activity, and therefore professional judgment represents a positive response by professionals to mitigate, to some degree, such inherent limitations. Since professional judgment represents a response intended to mitigate inherent limitations, professional judgment itself cannot be an inherent limitation, although, like any other human activity, the exercise of professional judgment is subject to inherent limitations.

7.3. The Purpose and Nature of Professional Standards

259. By definition, professional standards place restrictions on behaviour[88] – that is, standards reduce the number of acceptable alternative courses of action for professionals when they engage in their professional activities. Furthermore, they may include further guidance on the application of professional judgment in certain circumstances, which then also narrows the range of reasonable alternative actions. Consequently, standards serve to "standardise" professional behaviour by having professionals perform the same or similar acts when confronted with the same or similar circumstances subject to the standard or guidance. In other words, standards are promulgated because it is in the public interest (however defined) that professionals act appropriately when confronted with certain circumstances and because certain interest groups (stakeholders) seek certain behaviour from professionals when so confronted. Furthermore, harmonisation of professional responses to certain important circumstances tends to increase the credibility of the profession and its activities.

260. When issues arise for which it is of particular public interest (or the interest of certain important interest groups) that professionals respond in precisely the same way to precisely the same circumstances, and both the content of the response and the circumstances can be defined in a precise manner, then standards tend to move closer in nature to an algorithm. On the other hand, where complex matters with wide variation in circumstances are being addressed, it is not possible to draw up a list of procedures (an algorithm) always necessary. In these circumstances, standards tend to move closer in nature to broad principles with

[87] IFAC,IAASB Exposure Draft ISA 200.A25, April 2007.

[88] Kam, Vernon, "Accounting Theory", Second Edition, (John Wiley and Sons: New York, 1990), p. 554.

application or explanatory guidance, so that professionals are able to properly exercise their professional judgment.

7.4. The Professional Expertise of Auditors and Their Professional Judgment

261. The professional expertise of auditors is based upon the general elements necessary for professional expertise, including:

- University education or equivalent,
- Required periods of training and experience,
- Requirements for continuing professional development, and
- Professional ethics, ethos, and professional standards (including auditing standards).

262. These elements of professional expertise are set forth in professional and legal requirements, such as the IFAC Education Standards (which cover education, experience and continuing professional development); the IFAC Code of Ethics; the requirements in the EU Statutory Audit of Annual and Consolidated Accounts Directive for education, experience, continuing professional development, and independence; and national requirements for education, experience, continuing professional development and ethics (including independence).

263. In this sense, the basic nature of the professional expertise of auditors is not significantly different from that of lawyers or physicians. Lawyers require a university education or equivalent, have required periods of training and experience, are required to engage in continuing professional development, are subject to professional ethics requirement and professional standards, and have a professional ethos. Likewise, physicians require a university education, have required periods of training and experience, are required to engage in continuing professional education, are subject to professional ethics and professional standards, and have a professional ethos.

264. The need for professional judgment in the performance of audits arises from the need to exercise professional expertise in audits. Whether or not algorithms are *used* in audits, professional judgment is required in audits because audits cannot be reduced to an algorithm: the application of the requirements of financial reporting frameworks to the transactions and other events, and circumstances or conditions, of an entity, the application of auditing standards and guidance, and hence the audit process, all require significant interpretation and therefore the application of significant expertise on the part of an auditor. In other words, audits are not susceptible to algorithmic resolution because of the inherent limitations of an audit (see paragraph 143). An auditor's professional judgment enables an auditor to respond to, and hence mitigate in varying degrees, the inherent limitations of an audit.

7.5. Auditing Standards, Professional Judgment and the ISAs

7.5.1. The General Nature of Auditing Standards and Professional Judgment of Auditors

265. Auditing standards are professional standards. This means that they reduce the number of acceptable alternative courses of action for auditors (or eliminate the unacceptable, or help prevent the unacceptable being regarded as acceptable) when they perform an audit. Furthermore, guidance included in standards on the application of professional judgment in certain circumstances narrows the range of reasonable alternative actions in an audit.

266. Auditing standards serve to standardise professional behaviour by having auditors respond to the same or similar audit issues in the same or similar way: this is in the public interest

because auditors would then respond appropriately and similarly to those audit issues, which increases the credibility of audits and auditors.

267. When issues arise for which it is of particular public interest (or the interest of certain important interest groups) that auditors respond in precisely the same way to precisely the same circumstances, and both the content of the response and the circumstances can be defined in a precise manner, then auditing standards tend to move closer in nature to an algorithm (e.g., parts of the standards on the auditor's report). On the other hand, when complex matters with wide variation in circumstances are being addressed, auditing standards tend to move closer in nature to broad principles with application or explanatory guidance, so that auditors are able to properly exercise their professional judgment. Consequently, auditing standards address particular aspects of complex or difficult matters in an audit that require the application of professional judgment.

268. Given the need for the application of professional judgment, and hence professional expertise, in audits, which cannot be reduced to an algorithm, auditing standards cannot represent a comprehensive list of audit procedures applicable in all circumstances. Such standards can contain a short list of audit procedures that are almost always necessary in most circumstances plus broad principles with application guidance for all of the other circumstances. A definitive, comprehensive list of audit procedures (an algorithm) may reduce the application of professional judgment for complex matters with a wide variation in circumstances for very different entities and might lead to improper decision-making by auditors because they might not react to risks not foreseen by the algorithmic audit program.

269. Auditing standards also address the inherent limitations of audits and how auditors should deal with them. For example, the need for economical and timely audits as described in paragraphs 184 to 185 leads to auditing standards recognising the implications for audits as described in paragraph 185. In conclusion, auditing standards cannot apply an algorithmic approach to auditing because of the inherent limitations of an audit (see paragraph 143).

270. It would be improper to conclude that deficient auditor performance implies deficient auditing standards, or that deficient auditing standards automatically lead to deficient auditor performance (although deficient auditing standards certainly increase the risk of deficient auditor performance). However, it should be recognised that stakeholder pressure on auditing standards setters may cause the expectations gap to invert – that is, due to stakeholder pressure, auditing standards may include requirements or guidance that are not deliverable by auditors or audits, yet stakeholder expectations have been raised by auditing standards to beyond what audits can deliver[89]. Such a situation brings both auditors and audits into disrepute.

7.5.2. The Nature of the International Standards on Auditing (ISAs)

271. Under the new structure of the ISAs under the Clarity Project, the International Standards on Auditing (ISAs) include the objective of an audit and an overall objective of the auditor[90]. Furthermore, each ISA will include an objective (hereinafter referred to as the "objective in the standard") and requirements, as well as application material and other explanatory material (hereinafter referred to as "application material")[91]. By its nature, an objective cannot be expressed other than in a broad, principles-based manner. All ISAs include an introductory section, some of which that set the context for the standard and may provide a

[89] FEE Issues Paper "Principles of Assurance: Fundamental Theoretical Issues With Respect to Assurance in Assurance Engagements" (FEE: Brussels, April 2003), pp. 93-94.

[90] IFAC, IAASB Exposure Draft ISA 200.04-.06, .23-.25, April 2007.

[91] IFAC, IAASB Exposure Draft ISA 200.23-29, April 2007.

treatment of how the general inherent limitations of an audit may become specific ones in relation to the audit issues addressed in that standard[92].

272. The purpose of the objective of an audit is to define, in broad principles-based terms, what an auditor of financial statements is aiming to achieve in an audit. If, in the professional judgment of the auditor, this objective has not been achieved, then this has consequences for the audit opinion.

273. It is important to recognise that the objectives expressed in the ISAs are not absolute – that is, they are subject to considerations of both reasonable assurance and materiality. Since reasonable assurance, by definition, expresses the assurance that ought to be achieved given the inherent limitations of an audit (see paragraph 240), the objectives are subject to the inherent limitations of an audit.

Auditors must comply with the requirements of an ISA in all cases where such requirements are relevant[93]. Some requirements are expressed at a broad, principles-based level, whereas others are closer in nature to a rule, depending upon the degree to which the issue is susceptible to being resolved algorithmically. Nevertheless, since the wide range of circumstances and hence risks that may confront auditors cannot be foreseen, the ISAs allow auditors to depart from requirements when the requirement is not effective in meeting the objective of the requirement and the auditor documents how the aim of that requirement was achieved by means of alternative audit procedures[94]. The application guidance serves to help auditors by providing further explanation of, and guidance for carrying out (e.g., interpreting) the requirements[95] and provides additional guidance on the matters covered in the objectives.

274. Professional judgment in the application of the ISAs needs to be exercised in:

- Determining whether the objective of the audit has been achieved;
- In some cases, determining whether a standard is relevant;
- In some cases, determining whether a particular requirement in a relevant standard is relevant;
- Determining alternative audit procedures when a particular relevant requirement is not effective; and
- In some cases, interpreting a requirement and its application in light of the application material.

Overall, the application of considerable professional judgment is involved in applying the ISAs in a particular audit.

7.6. When and How Professional Judgment Ought to be Exercised in an Audit

275. Professional judgment is pervasive throughout an audit. It ranges from less important matters such as determining the wording of verbal inquiries in a discussion with entity staff to major issues impacting directly upon the content of the audit opinion. Strictly speaking, professional judgment needs to be applied in all circumstances where no rules exist or the rules require interpretation, but in particular when the application of expertise beyond the use of an algorithm is required.

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[92] IFAC, IAASB Exposure Draft ISA 200.A48, April 2007. See for example, IFAC, IAASB ISA 240 (Redrafted), 2007, paragraphs 5-8.

[93] IFAC, IAASB Exposure Draft ISA 200.27, April 2007.

[94] IFAC, IAASB Exposure Draft ISA 200.28, April 2007.

[95] IFAC, IAASB Exposure Draft ISA 200.A49, April 2007.

276. Examples of the major audit areas in which exercise of professional judgment is particularly important include:

- Client acceptance;
- Planning the audit and determining the nature, timing and extent of audit procedures;
- Applying engagement quality control policies and procedures;
- Determining materiality and "tolerable error";
- Designing and performing risk assessment procedures;
- Assessing the risks of material misstatement;
- Designing and performing further audit procedures in response to assessed risks;
- Evaluating decisions about accounting recognition, measurement, classification, presentation and disclosure in the financial statements;
- Evaluating the results of procedures performed and forming a conclusion;
- Evaluating the nature and strength of audit evidence;
- Determining whether sufficient appropriate audit evidence has been obtained;
- Evaluating the materiality of misstatements;
- Communicating with management or those charged with governance;
- Forming an audit opinion and, in some circumstances, drafting the auditor's report; and
- Determining the significance of matters for documentation.

277. Professional judgment needs to be exercised within the parameters provided by the relevant objectives in the ISAs as defined in greater detail by the requirements and explained by the application material. The application of professional judgment needs to be justifiable and reasonable given the professional expertise of the auditor and the context in which the professional judgment is exercised. In exercising professional judgment, like other professionals, auditors are held to the standard of the "prudent practitioner" – that is, what other prudent practitioners would do in similar circumstances[96].

278. It may be useful to provide a detailed example of some examples of matters for which an auditor exercises professional judgment in relation to a particular auditing standard. Examples of such key matters in relation to the application of Proposed ISA 320 (Revised and Redrafted) "Materiality in Planning and Performing the Audit" would be:

- Consideration of the discussion of materiality in the applicable financial reporting framework;
- Consideration of the common financial information needs of users as a group;
- Consideration of what may be expected to influence economic decisions by users taken on the basis of the financial statements as a whole in light of the surrounding circumstances;
- Determination of a quantitative materiality level for the financial statements as whole;
- Consideration of whether there are particular classes of transactions, account balances or disclosures for which misstatement of lesser amounts than the materiality level for the financial statements as a whole may be reasonably expected to influence the economic decisions of users taken on the basis of the financial statements, and if so, the determination of materiality in such circumstances;
- Determination of the expected rate of misstatements for the determination of "tolerable error"; and
- Determination of "tolerable error" for the financial statements as a whole, or for particular classes of transactions, account balances or disclosures, if applicable.

279. The importance of the determination of materiality and of tolerable error in relation to the "work effort" of the audit (and hence the level of assurance obtained by the auditor) is

96 Tom Lee, "Corporate Audit Theory", (Chapman & Hall: London, 1994) pp. 117-118.

discussed in paragraphs 128 to 129. Since the determination of materiality and tolerable error is subject to the exercise of considerable professional judgment, there is a question as to whether auditing standards provide a satisfactory basis for establishing whether auditor judgment with respect to materiality and tolerable error may have been set at inappropriate levels in order to justify too low levels of audit work and hence inappropriate levels of assurance. The key here is whether auditing standards provide sufficient guidance so that what is reasonable can be clearly distinguished from what is not and that the determination of materiality and tolerable error in practice for similar circumstances does not vary to such a degree that it calls into question the application of professional judgment for this issue.

280. Nevertheless, it should be recognised that this is a function that cannot be met by auditing standards alone. The comparability and reasonableness of professional judgment is in large part determined by the quality of the professional expertise based on other factors, such as education, training experience, etc., applied in that judgment, which is beyond the influence of auditing standards.

7.7. Documentation of Professional Judgment

281. An important question for auditors and reviewers, and hence audit oversight authorities, is how and to what extent the exercise of professional judgment in an audit ought to be documented. The current exposure draft Proposed Redrafted International Standards on Auditing ISA 230, "Audit Documentation" addresses the issue of audit documentation. In particular in paragraph 7 (c) the Proposed Standard requires the auditor to prepare audit documentation so as to enable an experienced auditor having no previous connection with the audit, to understand "significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions"[97].

282. The difficult questions to answer in this respect are the determination of when a matter is significant, and when professional judgments made are significant in reaching conclusions on significant matters. Clearly, there are very many more matters and judgments in an audit that are not significant than are, but having auditors document all of these decisions about whether matters or judgments are significant would lead to endless documentation by the auditor of decisions about the significance of matters or judgments that are not significant. Needless to say, this would further neither the quality of audits nor their reviewability.

283. A starting point may be to determine when a matter *is* clearly significant. Given the output of the audit process (the auditor's report), matters or judgments ought to be viewed as clearly significant when they affect the content of the auditor's report. However, does this mean that all matters and judgments that do not affect the content of the auditor's report are not significant? A better approach may be to recognise that the audit process represents a "chain" of justification, in which procedures performed and conclusions reached during the course of the audit build upon prior procedures performed and conclusions reached in the course of the audit. In this sense, whether a particular matter or judgment is significant depends upon whether that matter or judgment represents a necessary link in the chain justifying the content of the auditor's report. Hence, a matter or judgment is significant when a decision in relation to that matter, or the potential outcome of a judgment, respectively, *may* ultimately affect the content of the auditor's report.

[97] International Federation of Accountants (IFAC), International Auditing and Assurance Standards Board (IAASB) Exposure Draft, Proposed Revised and Redrafted International Standard on Auditing ISA 230, "Audit Documentation" (IFAC: New York, December 2006), paragraph 7 (c).

284. The remaining problem with this approach is the application of the word "may", which represents a rather unspecific threshold for determining significance. The threshold applied for the determination of the lowest acceptable level of audit risk is "acceptably low level of risk". Along these lines, then, one may argue that a matter, or judgment of a significant matter, is significant when, at the time the matter was addressed or the judgment was made, there was a greater than acceptably low level of risk that the decision about the matter, or the outcome of the judgment, would affect the content of the auditor's report (i.e., essentially that matter or its judgment represents a greater than acceptably low level of audit risk).. Consequently, the exercise of professional judgment is significant, and therefore should be documented, when the potential outcome of the exercise of that judgment has a greater than acceptably low level of risk of ultimately affecting an auditor's decisions on a significant matter at the time that judgment is made in the course of the audit.

285. Examples of areas in which the exercise of professional judgment would always include significant judgments about significant matters are given in paragraph 276. Examples of significant matters for which significant professional judgment needs to be exercised in relation to materiality are provided in paragraph 278. Examples of other matters that would always be significant include:

- The conclusion on the achievement of the overall audit objective;
- Departures from relevant standards or relevant requirements in relevant standards;
- Design of risk assessment procedures for obtaining an understanding of significant matters and significant assessments of misstatement risk;
- Significant assessments of risks of material misstatement;
- Design of significant audit procedures to respond to risks of material misstatement greater than at an acceptably low level; and
- Evaluation of the significant results from audit procedures.

286. In terms of what should be documented about the significant exercise of judgment, it appears that the following ought to be explicitly documented to the extent not otherwise apparent from the documentation of the performance of audit procedures:

- The determination that a matter is significant;
- The conclusions drawn in relation to that significant matter; and
- The significant professional judgments made to reach the conclusions in relation to that significant matter.

7.8. The Treatment of Professional Judgment in the ISAs

287. Professional judgment is mentioned in a number of ISAs in those cases where professional judgment is important in relation to the issues addressed in that particular ISA. There are two standards that address professional judgment in somewhat greater detail: ISA 200 "Objective and General Principles Governing An Audit of Financial Statements" and ISA 230 "Audit Documentation".

288. As noted, ISA 230.07 (c) states that significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions ought to be documented[98], and provides some examples of matters and judgemnts that should be documented when they are significant. However, the issue of significance is not addressed, nor explicitly what is to be documented when significant

[98] IFAC, (IAASB), Exposure Draft Proposed Revised and Redrafted International Standard on Auditing ISA 230.07(c), December 2006.

judgments for significant matters have been made. It may be advantageous for the ISA 230 to improve its treatment of documentation matters by addressing these issues in the application guidance as described in the previous Section.

289. ISA 200.19 suggests that professional judgment is an inherent limitation of an audit and provides a few examples of when professional judgment is exercised. It would be desirable that ISA 200 address professional judgment in greater detail and clarify, that professional judgment is not an inherent limitation, but rather, a response by auditors to inherent limitations. As such, professional judgment enables auditors to apply their expertise so that the overall objective of an audit can be achieved in light of the requirements. The new clarified exposure draft of ISA 200 does clarify further the meaning and role of professional judgment and ceases to treat it as an inherent limitation of an audit[99].

290. There have been questions by regulators about whether professional judgment allows auditors to "reduce" the assurance that is regarded as reasonable compared to absolute assurance. As demonstrated, not only is absolute assurance not attainable, but also, due to the varying assurance obtainable for independent assertions in the financial statements, reasonable assurance is not a constant within a particular financial statement audit. However, as was noted in the Sections 6.2.1 and 6.3.2 on audit evidence and reasonable assurance, respectively, auditors do not obtain all of the evidence, and hence assurance, obtainable, but rather, recognise that the acquisition of additional evidence, and hence the acquisition of additional assurance, is subject to diminishing returns.

291. Professional judgment enables auditors to determine when the point has been reached at which the benefit obtained in the acquisition of additional assurance is no longer worth the cost. In these circumstances, auditors acts on behalf of the other participants in the financial reporting supply chain in trying to the balance the costs and benefits among them in the public interest (see Section 5.5.2.2). To this effect, professional judgment does not "reduce" the assurance that is regarded as reasonable: it defines it. Consequently, reasonable assurance cannot be obtained independently of the use of professional judgment. These are matters that the IAASB may need to consider – and in particular, the link between professional judgment and reasonable assurance – when redrafting ISA 200.

292. Certain regulators are concerned that, as a result, professional judgment constitutes a "black box" that makes auditing standards (such as the ISAs), and hence audits unenforceable. The enforceability of audits and auditing standards given the need for the exercise of professional judgment in audits is therefore, the next matter addressed in this Paper.

[99] IFAC, IAASB Exposure Draft ISA 200.A24-A25, April 2007.

7.9. *The Main Conclusions Drawn in this Section*

293. The main conclusions drawn in this Section include:

- Professional judgment represents a positive response by professionals to mitigate, in varying degrees, inherent limitations. Hence professional judgment is, in itself, not an inherent limitation;
- Audits cannot be reduced to an algorithm: the application of the requirements of financial reporting frameworks to the transactions and other events, and circumstances or conditions, of an entity, the application of auditing standards and guidance, and hence the audit process, all require significant interpretation and therefore the application of significant expertise on the part of an auditor;
- Given the need for the application of professional judgment, and hence professional expertise, in audits, auditing standards cannot represent a comprehensive list of procedures applicable in all circumstances; such standards can contain a short list of procedures that are almost always necessary in most circumstances plus broad principles with application guidance for all of the other circumstances. A definitive, comprehensive list of procedures (an algorithm) would reduce the application of professional judgment for complex matters with a wide variation in circumstances and may lead to improper decision-making by professionals because they might not react to unforeseen risks;
- Overall, the application of considerable professional judgment is involved in applying the ISAs in a particular audit. Professional judgment needs to be exercised within the parameters provided by the relevant objectives in the ISAs as defined in greater detail by the requirements and explained by the application material. The application of professional judgment needs to be justifiable and reasonable given the professional expertise of the auditor and the context in which the professional judgment is exercised. In exercising professional judgment, like other professionals, auditors are held to the standard of the "prudent practitioner" – that is, what other prudent practitioners would do in similar circumstances;
- A matter is significant when an auditor's decisions about that matter at the time that matter is addressed in the course of the audit has a greater than acceptably low level of risk of ultimately affecting the content of the auditor's report. An auditor is required to document significant professional judgments made in reaching conclusions on significant matters arising during the audit. The exercise of professional judgment is significant, and therefore should be documented, when the potential outcome of the exercise of that judgment has a greater than acceptably low level of risk of ultimately affecting an auditor's decisions on a significant matter at the time that judgment is made in the course of the audit. It may be advantageous for the ISA 230 to improve its treatment of documentation matters by addressing this issue in the application guidance;
- It would be desirable that ISA 200 address professional judgment somewhat more than is currently the case and clarify, that professional judgment is not an inherent limitation, but rather, a response by auditors to inherent limitations. As such, professional judgment enables auditors to apply their expertise so that the overall objective of an audit can be achieved in light of the requirements; and
- Professional judgment enables auditors to determine when the point has been reached at which the benefit of the acquisition of additional assurance is no longer worth the cost (i.e., which is related to the question as to whether sufficient appropriate audit evidence has been obtained). In these circumstances, auditors act on behalf of the

other participants in the financial reporting supply chain in trying to the balance the costs and benefits among them in the public interest. To this effect, professional judgment does not “reduce” the assurance that is regarded as reasonable: it defines it. Consequently, reasonable assurance cannot be obtained independently of the use of professional judgement.

SECTION 8. THE ENFORCEABILITY OF AUDITING STANDARDS THAT REQUIRE THE USE OF PROFESSIONAL JUDGMENT

8.1. Purpose of this Section

294. The purpose of the Section is to examine the enforceability of auditing standards that require the use of professional judgment, and in particular, the ISAs given the need for professional judgment. To this effect, this Section examines:
   - The purpose of audit enforcement activities, so that a common understanding of enforcement is applied in the further analysis in the Paper;
   - The difference between the compliance and counselling aspects of enforcement activities resulting from the relationship between rules and judgment;
   - How enforcement authorities can scrutinise professional judgment;
   - Some prerequisites for effective audit enforcement given the need to enforce compliance and scrutinise professional judgment;
   - The enforceability of auditing standards and hence audits given the exercise of professional judgment; and
   - The importance that regulatory attention be given to other parts of the financial reporting supply chain.

   However, this Section does not deal with enforcement of audits and the enforceability of auditing standards in a wider sense than noted above because this would be beyond the mandate of the Paper and require considerable additional analyses.

8.2. The Purpose of Audit Enforcement Activities

295. The word "enforcement" refers to an activity by which an authority compels the observance of particular norms: it represents an activity separate from the creation of norms. However, enforcement does involve the interpretation of norms by an authority to determine whether particular conditions or activities constitute non-observance. Enforcement also involves the exercise of power to compel observance.

296. Compelling observance implies that an enforcement authority exercises its power to 1. deter non-observance when the potential for non-observance exists, 2. prevent non-observance by hindering the occurrence of events causing a condition of non-observance or hindering actions constituting non-observance when attempted, 3. detect non-observance when it exists or occurs, 4. correct or mitigate detected non-observance. All four steps imply that the authority apply its power to interpret whether the potential (or actual) event, condition or action would (or does) constitute non-observance. Hence, the purpose of enforcement activities is essentially to drive events or behaviour towards observance. Since observance of the rules is not an end in itself, but is usually related to some quality objective, the underlying purpose of enforcement is to improve quality.

297. Deterrence is generally achieved by means of the power of the authority to cause uncomfortable consequences for non-observance, usually by means of imposing effective sanctions (allowing other affected parties to sue for damages, imposing penalties, or forcing correction or mitigation at the cost of the perpetrator). Deterrence is predicated upon a reasonable likelihood that non-observance would be detected. Deterrence can also be

achieved by prevention together with sanctions for attempted non-observance, but prevention is a very costly means of deterrence because it involves continual surveillance so that prevention can take place before an actual case of non-observance occurs. Hence, most enforcement involves "after-the-fact" detection, correction, or mitigation together with deterrence through sanctions for detected non-observance.

298. Nevertheless, as noted in Section 7.2, professional activities by definition involve the application of professional judgment and hence professional expertise. Consequently, when engaging in enforcement activities over professional activities, effective enforcement is not confined to compelling compliance with the relevant norms or rules. Enforcement it may also involve obtaining an understanding of the reasonableness of the professional judgment exercised by the professional in the conduct of their professional activity beyond observance with the rules, since the quality of the activity also depends upon the quality of the professional judgments made beyond mere compliance. The experience gained by enforcement authorities may be of use in enhancing the quality of the professional activity (counselling).

299. Hence, the purpose of audit enforcement activities is to enforce the compliance of audits with applicable rules *and* to improve the quality of audits through counselling: in other words, overall, to reduce the likelihood of inadequate audits and improve audits. The results of enforcement activities can be used as inputs (feedback) into auditing standards setting (i.e., improving the norms) or to improve the enforcement activities themselves.

8.3. Compliance and Counselling in Audit Enforcement

300. As noted in paragraphs 298 and 299, enforcement of professional activities involves two aspects: "compliance" and "counselling". "Compliance" refers to the traditional task of enforcement, which is to compel observance with certain rules – which generally involves "after-the-fact" detection, correction, or mitigation together with deterrence through sanctions for detected non-observance (see paragraph 297). "Counselling" refers to obtaining an understanding of the reasonableness of the exercise of professional judgment to allow counselling on the improvement of its exercise. The difference between the two aspects of the enforcement of professional activities can be clarified by examining the general characteristics of each.

301. One of the primary characteristics of the compliance aspect is its binary conclusion: either the audit was performed in compliance with the applicable norms (legislation, regulation and rules within standards) or it was not. If it is not possible for the enforcement authority to determine whether the audit is in compliance with applicable norms due to circumstances beyond the control of the auditor, then there must be a presumption that the auditor is in compliance (the presumption of "innocence"). If it is not possible for the enforcement authority to determine whether the audit is in compliance with applicable norms because of actions undertaken or not undertaken by the auditor that should not, or should, ordinarily be undertaken, respectively, then there must be a presumption that the audit is not in compliance (the onus is on the auditor to prove his or her "innocence").

302. The rules need to be applied to the facts of the case. Accordingly, the compliance aspect does not lend itself to the evaluation of professional judgment beyond a determination of whether the conclusion drawn from the application of that judgment was clearly unreasonable in the circumstances (i.e. it is limited to determining violation of rules). Furthermore, such application is limited to matters of "fact" – that is, matters of opinion, even when supported by some evidence, cannot be subjected to tests of compliance. The compliance aspect of enforcement is very effective against serious abuses that manifest themselves in violation of

rules because it forms the basis for the imposition of sanctions. However, since audits are permeated by professional judgment for many significant issues, the compliance approach is only of limited value for the improvement of auditor performance beyond mere compliance.

303. One of the primary characteristics of the counselling aspect is its culmination in recommendations for potential improvement without being able to draw on conclusive evidence that a violation of applicable rules has occurred. Rather, the counselling aspect involves the discussion by the reviewer with the auditor of the application of professional judgment to judgmental issues within the "range of reasonableness" in light of the surrounding circumstances at the time the judgment was made. The objective is to understand the reasonableness of the professional judgment and to assist the auditor in improving the exercise of professional judgment by providing recommendations for improvement. Such an approach is not appropriate for compliance decisions and therefore cannot form an appropriate basis for sanctions. However, since audits are permeated by professional judgment for many significant issues, the counselling aspect does promise greater effectiveness than just mere compliance in assisting auditors to improve overall auditor performance.

8.4. The Scrutiny of Professional Judgment by Audit Enforcement Authorities

304. It is clear that the high degree of professional judgment required to address many significant issues involved in the performance of audits bears with it the difficulty that in meeting their enforcement responsibilities, audit enforcement authorities would need to scrutinise the exercise of professional judgment by auditors. This applies both to the need to scrutinise the exercise of professional judgment in a compliance context (i.e., the determination of whether the conclusions reached by means of the application of professional judgment are clearly unreasonable in the circumstances) and in a counselling context (i.e., discussion with the auditor to assist auditor performance in the exercise of professional judgment). However, the ability of reviewers to scrutinise the professional judgment exercised by auditors in the performance of audits depends upon the expertise of those reviewers.

305. Given that professional expertise is required to exercise professional judgment (see paragraph 256), it follows that essentially the same – if not more – professional expertise is required of reviewers that scrutinise the exercise of that professional judgment. This means that reviewers of audits ought to dispose of the same professional expertise as outlined in paragraph 251 for professionals generally and paragraph 261 for auditing. Such exercise of professional expertise by audit reviewers would also need to take place in the same context as the exercise of professional judgment by the auditor – that is, in the context of the applicable auditing standards, financial reporting framework and ethical standards, etc. as noted in paragraph 251. The scrutiny by audit reviewers of the application of professional judgment by auditors in audits would need to:

    (i) Recognise the subjective nature of such judgments;
    (ii) Facilitate the need for broad consistency of judgment among practitioners in similar circumstances (see paragraph 257); and
    (iii) Only use the information that should have been obtained by the auditor at the time the judgment was made and therefore not benefit from hindsight.

    Although audit reviewers make decisions on compliance and would counsel auditors based on their scrutiny of the exercise of professional judgment by the auditor, the final arbiters of the reasonableness of professional judgment exercised by auditors in a compliance sense are the courts of law using the testimony of expert auditor witnesses.

8.5. Some Prerequisites for Effective Audit Enforcement

306. There are a number of prerequisites for effective audit enforcement by audit enforcement authorities. The FEE Paper "Quality Assurance Arrangement Across Europe" (hereinafter referred to as the "FEE Quality Assurance Paper") issued in December 2006 provides a list of recommendations for a system of quality assurance, but also notes that this list is not exhaustive and therefore provides some other examples of other aspects of quality assurance systems[100]. This Paper is confined to examining those issues leading to prerequisites that result from the other analyses in this Paper and are particularly important in this context. It should be noted that these prerequisites apply regardless of the system of enforcement in place (e.g., monitoring versus monitored peer review systems for quality assurance).

307. One of the primary prerequisites for effective enforcement are norms for which audits can be subjected to tests of compliance. Legislation and regulations of statutory audits do provide some norms for which audits can be subjected to tests of compliance. However, auditing standards represent the key criteria used as a basis for testing the compliance of audits. Hence the enforceability of auditing standards also depends on the degree to which they contain at least some "rules" that represent high-level principles that can be applied in determining compliance. A relevant example, in part, is the requirement in paragraph 6 in the ISA 300 (Redrafted), "Planning an Audit of Financial Statements" that "The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and guides the development of the audit plan"[101]. If, for example, an auditor has not established an overall audit strategy, then this is a clear violation of the "rule". However, the extent to which an audit strategy actually guided the development of an audit plan and whether that plan adheres closely enough to the audit strategy may be a judgmental issue that is not necessarily susceptible to a pure test of compliance unless it is clear that the audit plan bears little resemblance to the audit strategy.

308. As the FEE Quality Assurance Paper noted, national auditing standards, of which three-quarters are closely related to the ISAs, appear to provide an adequate basis for the compliance aspect of audit enforcement, for only two organisations in EU Member States appear to have experienced difficulty in enforcing their current principles-based standards[102]. Hence, the ISAs appear to be enforceable auditing standards from a compliance perspective. Furthermore, from a counselling perspective, the considerable application material in the ISAs provides useful guidance on quality criteria to allow reviewer scrutiny of the exercise of professional judgment in audits.

309. Enforcement cannot be effective unless it deters, prevents or detects non-observance of norms. Given the need for enforcement to detect non-observance of norms "after-the-fact" rather than the prevention of non-observance (see paragraph 297), effective enforcement encompasses external quality assurance (inspections) and investigations by, or on behalf of, the audit enforcement authority. The effectiveness of such inspections and investigations are, in turn, predicated on adequate standards for the performance of such inspections and investigations and on reviewer access to evidence of audit performance. Since reviewers need evidence of audit performance, another important prerequisite for audit enforcement, is adequate audit documentation. To this effect, ISA 230 "Audit Documentation" provides clear requirements on the documentation necessary.

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[100] Fédération des Experts Comptables Européens (FEE), Quality Assurance Arrangements Across Europe, (FEE: Brussels, December 2006), pp. 16-17.

[101] IFAC, IAASB ISA 300 (Redrafted), "Planning an Audit of Financial Statements", 2007, paragraph 6.

[102] FEE, December 2006, p. 16.

310. However, in light of the need for reviewers performing inspections or investigations to determine whether the exercise of professional judgment was reasonable in the circumstances and to enable them to counsel auditors on the improvement of their exercise of professional judgment (see paragraphs 304 and 305), appropriate professional expertise on the part of the reviewer is one of the most crucial prerequisites for effective audit enforcement[103]. This implies that reviewers ought to have, among other things, professional expertise in auditing, the application of auditing and accounting standards, professional ethics, etc. In particular, professional expertise in auditing signifies expertise in such matters as an understanding of materiality, financial statement assertions, risk assessment, responses to risk, the evaluation of audit evidence, the significance of matters to the audit report, and the exercise of professional judgment.

311. The recruitment and retention of suitably qualified individuals with adequate professional expertise as reviewers for the performance of inspections and investigations for the audit enforcement authority also implies that the inspections and investigations of the enforcement function ought to be adequately funded so that the reviewers are adequately remunerated for their services[104].

8.6. The Enforceability of Auditing Standards and Hence Audits

312. Section 7.8 addresses concerns that some regulators have about the application of professional judgment and that it may constitute a "black box" as regards the enforceability of the ISAs. As shown in Section 8.4, the exercise of professional judgment by auditors is not a "black box" as long as those performing enforcement functions have the necessary expertise to scrutinise the reasonableness of the professional judgment exercised by auditors. Consequently, auditing standards that recognise the need for professional judgment and hence audits in which professional judgment is exercised are enforceable.

313. It may be useful for regulators and enforcement authorities to recognise that audit processes cannot be, and therefore are not, structured in accordance with the structure of auditing standards. Rather, as noted in paragraph 125, audit processes are largely driven, and hence structured, by the financial statement assertions that ought to be contained in the financial statements (or the business or accounting processes that give rise to these), for that is what auditors obtain evidence about to enable them to form an opinion about whether the financial statements are free of material misstatement, which, after all, is the objective of an audit.

314. Attempts to design or use auditing standards as a "compliance checklist" for audit enforcement purposes will not be effective. Nevertheless, the content of auditing standards will influence the way in which enforcement authorities inspect audits. For this reason, enforcement of audits needs to be directed towards the audit process in light of the applicable auditing standards, rather than be driven solely by the structure of the auditing standards.

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103 See FEE, December 2006, p. 56, which covers appropriate professional qualification, professional experience in audit work and financial reporting, and introductory training in performing quality assurance reviews and reporting thereon. See also FEE, p. 17, which, in point 10 addresses that reviewers require the necessary competencies acquired through initial education, continuing education and training with relevant professional experience.

104 See FEE, December 2006, pp. 14 and 15, which notes that the ability to recruit non-practitioners because of the limited size of the profession or due to restricted funding of the review organisation.

8.7. *Importance of Other Parts of the Financial Reporting Supply Chain*

315. Section 3.2.3 introduces the notion of the "financial reporting supply chain", of which audits and auditors are only one link in that chain. The Appendix provides some examples of the matters affecting audits for which participants other than auditors are responsible. Paragraph 143 notes that auditors have no control over the other parts of the financial reporting supply chain. By definition, a chain is only as strong as its weakest link (see paragraph 72). Hence, the value-added of audits, and hence the value of audits within the financial reporting supply chain, depend very much on the other parts of the financial reporting supply chain.

316. For this reason, regulation and effective enforcement over audits does not necessarily mitigate weaknesses in other parts of the financial reporting supply chain. For example, weaknesses in the applicable financial reporting framework (e.g., insufficiently relevant or insufficiently reliable information that may be required by accounting standards) generally cannot be alleviated by means of the audit process. Likewise, auditors have no control over the kinds of transactions that entities engage in: contractually unclear transactions lead to uncertainties in accounting treatment that cannot be ameliorated by means of an audit. Furthermore, this also means that what auditing standards can achieve in improvement of auditor performance is being subjected increasingly to diminishing returns. Therefore, consideration may need to be given to whether regulation and enforcement, in the public interest, of other parts of the financial reporting supply chain is adequate.

317. One example of issues at a preparer level that may be the subject for the consideration of further regulation and enforcement beyond audits, auditors and auditing standards might include accounting credentials for those below general management with responsibility for financial reporting of public interest entities and ethical standards for preparers, etc. Such measures, and others, represent matters upon which regulators and enforcement authorities may need to reflect, rather than recommendations for action.

8.8. The Main Conclusions Drawn in this Section

318. The main conclusions drawn in this Section include:

- Reviewers with the appropriate expertise are able to scrutinise the reasonableness of significant professional judgment exercised by an auditor in the course of an audit. In particular, reviewers with the appropriate expertise are able to identify when the application of professional judgment in a particular instance may be clearly unreasonable;
- Given that professional expertise is required to exercise professional judgment, it follows that essentially the same professional expertise is required of reviewers that scrutinise the exercise of that professional judgment. Such exercise of professional expertise by audit reviewers would also need to take place in the same context as the exercise of professional judgment by the auditor – that is, in the context of the applicable auditing standards, financial reporting framework and ethical standards, etc.;
- Regardless of the system of enforcement in place (e.g., monitoring versus monitored peer review systems of quality assurance), reviewers ought to have, among other things, professional expertise in auditing, the application of auditing and accounting standards, professional ethics, etc. In particular, professional expertise in auditing signifies expertise in such matters as an understanding of materiality, financial statement assertions, risk assessment, responses to risk, the evaluation of audit evidence, the significance of matters to the audit report, and the exercise of professional judgment;
- The exercise of professional judgment by auditors is not a “black box” as long as those performing enforcement functions have, apart from the necessary information, the necessary expertise to scrutinise the reasonableness of the professional judgment exercised by auditors. Consequently, auditing standards that recognise the need for professional judgment and hence audits in which professional judgments is exercised are enforceable;
- It may be useful for regulators and enforcement authorities to recognise that audit processes cannot be, and therefore are not, structured in accordance with the structure of auditing standards. Rather audit processes are largely driven, and hence structured, by the financial statement assertions that ought to be contained in the financial statements, for that is what auditors obtain evidence about to enable them to form an opinion about whether the financial statements are free of material misstatement, which, after all, is the objective of an audit. Consequently, attempts to design or use auditing standards as a “compliance checklist” for audit enforcement purposes will not be effective. Nevertheless, the content of auditing standards will influence the way in which regulators inspect audits. For this reason, enforcement of audits needs to be directed towards the audit process in light of the applicable auditing standards, rather than be driven solely by the structure of the auditing standards; and
- Enforceability of auditing standards is part of a broader issue of regulation and enforcement over auditing and the rest of the financial reporting supply chain. Regulation and effective enforcement over audits does not necessarily mitigate weaknesses in other parts of the financial reporting supply chain and is being subjected to diminishing returns. Therefore consideration may need to be given to whether regulation and enforcement, in the public interest, of other parts of the financial reporting supply chain is adequate.

SECTION 9. VALUE-ADDED OF AUDITS

9.1. Purpose of this Section

319. The purpose of the Section is to place the inherent limitations of an audit into an overall perspective of the value-added of audits by:
- Noting the general relationship between value-added and inherent limitations,
- Discussing the benefits of audits,
- Addressing the cost of audits, and
- Pointing out the value-added of audits.

9.2. General Considerations About Inherent Limitations and Value-Added

320. The focus of this Paper is the inherent limitations of an audit and related issues – in other words, on what audits cannot or should not be expected to deliver. However, this focus leaves a somewhat distorted impression about the value of audits – and in particular, the value-added of audits in the financial reporting supply chain. It is therefore appropriate to provide some balance in this Paper by briefly outlining what audits can and should do, and hence the value-added of audits despite their inherent limitations. It is not the purpose of this Paper to provide an exhaustive analysis or provide empirical evidence on the benefits or costs of audits.

321. It is in the nature of all systems that they are subject to systems failure in certain circumstances due to the inherent limitations of those systems. For example, it is not unknown that individuals have been unjustly convicted for crimes in most – if not all – legal systems. Likewise, misdiagnoses of ailments afflicting patients occur in every country with a functioning medical system. Despite the inherent limitations on legal and medical systems, few would seriously call into question the need for such systems. By the same token, audit failures need not cause reflection about whether audits as a service (or the entire audit model) need to be called into question, even if major failures may prompt examination of whether improvements can be made. Furthermore, it should be pointed out that business failures ascribed to auditors actually arise from failed corporate strategies or execution of strategies or corporate governance failures.

322. In large part the effectiveness of audit systems in society are, or ought to be, determined by political decisions in society about the allocation of resources and obligations in the financial reporting supply chain based on the relative costs and benefits of such allocation. The relative economic costs and benefits of audits within the financial reporting supply chain are often analysed using agency theory, as addressed in paragraph 68. Agency theory represents a useful theory of accountability that helps explain the development of audits and the audit process, but there are ranges of stakeholders and regulators that may make adjustments to the interpretation or operation of the theory in practice to ensure that the public interest is indeed served.

9.3. *The Benefits of Audits*

323. Decisions about the relative costs and benefits of audits require identification and quantification of the benefits. The benefits of audits are difficult to quantify, but the supposed benefits can be identified. The benefits at a financial reporting level can be divided into deterrence on the one hand, and detection and correction on the other hand.

324. The fact that an audit will be performed may have an impact on the behaviour of those responsible for preparing and presenting the financial statements or those whose activities have an effect on this process: in other words, an audit may act as a deterrent to fraud or error. For example, the fact that an audit will be performed may make management seek to remedy weaknesses in internal control over fraud and error prior to the commencement of the audit so that management is seen to be fulfilling its responsibilities over financial reporting and internal control by those charged with governance. Likewise, management and those also responsible for preparing and presenting the financial statements may exercise greater diligence rather than have auditors uncover error caused by a lack of care in such preparation. Both of these actions by management and those also responsible for preparing and presenting the financial statements would also serve to reduce audit costs.

325. The fact that a financial statement audit will be performed will also deter some with an opportunity and motive to commit fraud (including the application of clearly unreasonable judgments by management) from doing so: in any case, the fact that a financial statement audit will be performed increases the hurdle for fraud because the audit makes it necessary for the perpetrator of the fraud to engage in sophisticated concealment activities or to collude with others, which makes fraud a much more difficult proposition (see also the effect on control risk in paragraph 118).

326. The question about the degree of deterrence provided by audits for fraud and error might be answered by looking back to the situation prior to audits of financial statements being required for publicly-listed entities (i.e., in the 1920's in most of industrialised Europe and in the U.S.), when errors, fraud and manipulation of financial information were the order of the day in financial markets, and by looking at the accounting practices and ethics in emerging markets (e.g., Eastern Europe) prior to the establishment of effective audit requirements in those markets.

327. On the other hand, as paragraph 118 points out, in some circumstances there may be a moral hazard that management and others involved in the preparation and presentation of the financial statements may not be as diligent because of the expectation that the auditor would detect material misstatements through the audit.

328. The other benefit of audits at a financial statement level relates to the audit detecting and correcting material misstatements in the financial statements. Audits are well-designed for, and as currently practiced, do have a reasonable success rate in, detecting material misstatements in the financial statements where such misstatements can be categorised as misstatements of fact due to error. Audits also have a reasonable success rate in detecting material misstatements resulting from judgmental misstatements due to error where management judgments are clearly unreasonable. However, due to the inherent limitations associated with judgmental issues, the detection of material misstatements when management judgments are not clearly unreasonable is much more difficult for auditors to detect.

329. Audits of financial statements are also designed, subject to the inherent limitations of an audit, to detect material misstatements resulting from fraud. Because they have less opportunity to override internal control or collude with senior third parties, material fraud perpetrated by employees is more easily detected by audits than fraud perpetrated by management. Due to the inherent limitations of an audit generally and in relation to fraud in

particular, financial statement audits are not very effective in detecting management fraud, which often involves the override of internal control in combination with weak corporate governance, sophisticated concealment through the falsification of documents and collusion with third parties.

330. The inherent limitations of an audit in relation to access to evidence, and the economic and time constraints under which audits can realistically be performed, also have an impact on an auditor's ability to detect fraud. In 1998 the UK Auditing Practices Board (APB) published a consultation paper "Fraud and Audit: Choices for Society" precisely in order to assess the extent to which the British public viewed the performance by auditors of their traditional role in relation to the risk of material misstatement caused by fraud. At the time, there was a view expressed by some stakeholders that perhaps auditors should do more to detect material fraud, including those frauds involving senior management[105]. However the APB's conclusion based on the consultation was that there was no significant appetite to change the auditor's responsibilities in relation to fraud or to increase the nature or extent of audit work. In other words, it was recognised that audits may not detect all material frauds, particularly collusive fraud involving senior management, but the additional cost of investigation that would be required on all audits to reduce the risk of such fraud not being detected was not economically viable when applied to the whole range of public interest entities, including well-managed organisations[106].

331. At a capital markets level, the benefit of audits of financial statements at a financial statement level translate into lower costs of capital for entities, as well as a significant contribution to the reduction in transactions costs for the purchase and sale of businesses. Furthermore, audits facilitate enterprise access to capital – particularly SME access to capital.

332. Overall, it appears that the benefits of audits of financial statements are considerable, both at a financial statement and capital markets level. This is so even though audits have rather limited effectiveness in the detection of material sophisticated management fraud involving collusion with third parties and the falsification of documents, and even though it is often difficult for auditors to determine whether management's judgments are reasonable.

9.4. The Cost of Audits

333. The costs of audits are related to the inputs into the audit process and the constraints on that process by the financial reporting supply chain, including legislation, regulation and auditing standards; the onerousness of the requirements of the applicable financial reporting framework; the complexity and uncertainty associated with the transactions, other events and circumstances and conditions, of an entity; and the cost of obtaining sufficient appropriate audit evidence. The cost of performing an audit is also a function of the degree of professional expertise required to perform an audit: highly qualified and capable individuals would not be prepared to enter the auditing profession unless the remuneration for audit services appropriately reflected the cost of obtaining and maintaining that expertise and the opportunity cost resulting from the ability of such highly qualified and capable individuals to provide services or engage in employment other than audits. Hence, high quality audits involving the exercise of professional judgment are an expensive service.

334. It should also be pointed out that in a number of major jurisdictions, in which auditors are

[105] The Auditing Practices Board (APB), Consultation Paper "Fraud and Audit: Choices for Society", (APB: London, November 1998), pp. 2-3.

[106] Auditing Practices Board (APB), 2000 APB Annual Review, (APB: London, 2001), p.5.

subject to unlimited liability to third parties, large audit firms cannot obtain complete coverage for auditor liability at any price, which means that these firms must "self-insure" (assume the risk). Furthermore, suggestions by some academics to have publicly listed entities take out material misstatement insurance have foundered on the large insurance premiums that would be involved – premiums that would exceed audit fees by at least an order of magnitude. These circumstances suggest that in some jurisdictions, audit fees may not cover the actuarial risk associated with audit engagements.

335. Well-managed entities, on the other hand, argue that their audit cost burden is excessive – especially since they must bear the audit costs resulting from audit requirements designed to respond to improper accounting – whether intentional or unintentional. This may be true, but it is the performance of an audit that allows the determination of whether an entity is well-managed from a financial reporting perspective.

9.5. The Value-Added of Audits

336. Although audits are subject to inherent limitations, the complex audit services requiring considerable professional expertise are being made available to users of financial statements of most entities at reasonable cost. The benefits of audits outweigh their costs considerably: this explains the large market for voluntary audits of financial statements by entities not required to have a statutory audit. A case can be made at a purely economic level, that the costs of audits outweigh their benefits for micro entities – that is, when the size of the entity is so small, that the cost of the audit begins to become significant to the financial position, financial performance or cash flows of the entity (e.g., normalised income or residual equity holders' capital). However, with the exception of some jurisdictions, these entities are generally not subject to statutory requirements for audits unless there are non-economic reasons for requiring an audit.

337. On this basis, despite the inherent limitation of an audit, a strong case can be made that auditors provide a high value-added service to other participants in the financial reporting supply chain and hence to the economy as a whole.

9.6. The Main Conclusions Drawn in this Section

338. The main conclusions drawn in this Section include:

- Audit failures need not cause reflection about whether audits as a service (or the entire audit model) need to be called into question, even if major failures may prompt examination of whether improvements can be made. Business failures often ascribed to auditors arise from failed corporate strategies or execution of strategies or corporate governance failures;
- In large part the effectiveness of audit systems in society are, or ought to be, determined by political decisions in society about the allocation of resources and obligations in the financial reporting supply chain based on the relative costs and benefits of such allocation;
- Overall, it appears that the benefits of audits of financial statements are considerable, both at a financial statement and capital markets level. This is so even though audits have rather limited effectiveness in the detection of material sophisticated management fraud involving collusion with third parties and the falsification of documents, and even though it is difficult for auditors to determine whether management judgments are reasonable; and
- On this basis, despite the inherent limitations of an audit, a strong case can be made that auditors provide a high value-added service to other participants in the financial reporting supply chain and hence to the economy as a whole.

APPENDIX : A SHORT INFORMAL TREATMENT OF EXAMPLES OF THE RESPONSIBILITIES OF PARTICIPANTS IN THE FINANCIAL REPORTING SUPPLY CHAIN

Accounting Regulators:

- Choice of financial reporting framework, enforcement of application of financial reporting framework by preparers, influence on accounting standards setters, requirements for audits, etc.

Accounting Standards Setters:

- Usefulness (relevance, reliability, understandability, and optimisation of relative costs and benefits) of financial statements resulting from the application of the financial reporting frameworks designed by the accounting standards setters.

Entities whose financial statements are subject to audit:

- The choices over the entity's environment; the nature of the entity (the entity's operations, its ownership and governance, the types of investments that it is making and plans to make, the structure of the entity and how it is financed); the entity's objectives, strategies and related business risks; measurement and review of the entity's financial performance: all of which affect the events and circumstances to which the applicable financial reporting framework is applied.

Preparers (Professional Accountants in Industry, and Management):

- Quality of application of financial reporting framework in the preparation of the financial statements, in part, through design, implementation and maintenance of adequate internal control relevant to the preparation and presentation of the financial statements, and through the choice of appropriate accounting policies.

Those Charged With Governance:

- Effective oversight over management's establishment of internal controls over financial reporting and preparation of the financial statements.

Auditing Standards Setters:

- Auditing standards in the public interest that serve audits: 1. that meet user needs, 2. whose benefits exceed their cost, and 3. and whose requirements are deliverable.

Ethics Standards Setters:

- Ethics standards for professional accountants in industry and auditors that serve the public interest by ensuring appropriate ethical standards such that their benefits exceed their cost and public confidence is maintained in the accounting and auditing process.

Auditing Oversight Authorities:

- Quality of audit regulation, oversight and enforcement; influence on auditing standards setters.

Users (e.g., Investment Bankers, Analysts, Credit Rating Agencies, Investors, Creditors, Employees, Consumers):

- The acceptance and maintenance of education about the purpose and meaning of financial statements and their audit: the appropriateness of the use to which financial statements and audit reports are put.

- The degree to which users are prepared to pay (or exert political or economic pressure to have entities pay) for information from assurance services.

Legal Profession:

- The degree to which accounting and auditing retain the primacy of an economic over legal (compliance, or purely legal subsumption) perspective (economic substance over legal form).

Academics:

- Appropriateness of research in, and theoretical foundations for, accounting, auditing, corporate governance, internal control, regulatory policy, user needs, operation of financial markets, financial analysis, etc.

Educators:

- Quality of financial, accounting and other relevant education of other parties, including academics, accounting standards setters, accounting regulators, preparers (professional accountants in industry and management), those charged with governance, auditing standards setters, accounting education standards setters, ethics standards setters, auditing oversight authorities, professional bodies, legal profession, and users (investment bankers, analysts, credit rating agencies, consumers).

Accountancy Education Standards Setters:

- Education standards for accountants, including auditors, that meet the public interest and make accountancy and audit an attractive profession[107].

[107] Parts of this treatment have been adapted from the Report of Independent IFAC Task Force on Rebuilding Confidence in Financial Reporting.