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Dear Mr Sylph

Proposed International Standard on Auditing 200 (Revised and Redrafted) Overall Objective of the Independent Auditor, and the Conduct of an Audit in Accordance with International Standards on Auditing

The Committee of European Banking Supervisors welcomes the opportunity to comment on the Proposed International Standard on Auditing 200 (Revised and Redrafted) Overall Objective of the Independent Auditor, and the Conduct of an Audit in Accordance with International Standards on Auditing (ED).

Through their opinions on annual accounts and annual reports, external auditors constitute an integral part of the public oversight model and contribute to the financial stability of the market. As banking supervisors we therefore have an interest in ensuring that auditing standards, which are the basis for audit work, are of a high quality and are clear and capable of consistent application.

We appreciate the efforts of the International Auditing and Assurance Standards Board (IAASB) to clarify the auditing standard. In particular, we appreciate the changes to the wording concerning the obligation attaching to objectives, and the removal of the 'aim to achieve'. However, we believe some further work is necessary to ensure that this key auditing standard is sufficiently clear and rigorous and sets an appropriate tone for the whole suite of ISAs. Currently the ED seems to have an excessively defensive tone about what an auditor is able to deliver in an audit and we are not sure it would drive appropriate auditor behaviour for a high quality audit. In particular, we have concerns about:

- (a) the organisation and overall clarity of the ED;
- (b) how all the concepts relate to each other and the overall description of the objective of the audit and the auditor; and
- (c) the definition and application of the terms professional judgement, inherent limitations of an audit and professional scepticism.

We expand on each of these aspects in the attached appendix. The appendix presents our comments on the ED in the order in which the ED is presented.

Our comments were coordinated by our Expert Group on Financial Information (EGFI), and especially by its Subgroup on Auditing, which is under the direction of Pat Sucher from the FSA, UK.

If you have any questions regarding our comments, please feel free to contact the chairman of EGFI, Arnoud Vossen (+31.20.524.3903) or Miss Pat Sucher (+44.20.7066.5644).

Yours sincerely

A handwritten signature in black ink, appearing to be 'DN' or similar initials, written in a cursive style.

Daniele Nouy
Chair

CEBS comments on IAASB exposure draft Proposed International Standard on Auditing 200 (Revised and Redrafted) Overall Objective of the Independent Auditor, and the Conduct of an Audit in Accordance with International Standards on Auditing (ED) Responses to the IAASB's questions**Overall organisation and clarity of the ED**

We are concerned that this ED, which 'establishes the independent auditor's overall responsibilities when conducting an audit in accordance with ISAs'¹ is not as well organised and clear as would be appropriate for such a key ISA. There is a certain amount of repetition of the reference to or discussion of some terms (e.g. professional scepticism, reasonable assurance), which does not aid clarity. There is also a discussion of concepts, some of which overlaps with the definitions, which is not as clear as it could be about what is the purpose of an audit. We refer to several of these points in more detail in the paragraphs below. These paragraphs below present our comments in the order of the ISA, rather than in the order of importance.

Scope of the ISA

As currently described, this paragraph, which covers the scope of the ED, is not correct. The ED covers the overall objective of the independent auditor and the key concepts relevant to the audit. However, it also covers the scope and authority of the ISAs and the scope paragraph should be amended to reflect this.

Overall objective of the Independent auditor

It seems to us that the separate references to the objective of the audit and to the objective of the auditor may confuse rather than clarify what is the overall objective of the independent auditor. Therefore they are likely to detract from what should be the main focus on this section – the overall objective of the auditor. The overall objective could also be expressed in a more direct manner.

In addition, paragraph 5 seems to indicate that the overall objective of an auditor includes providing a modified opinion, where appropriate. However, paragraph 6 then states that unless the overall objective of the auditor is achieved, the auditor has to modify his opinion. These two paragraphs seem to contradict each other.

We believe it would be more helpful if a separate section was provided in the ED where there was a clear expression of the overall purpose of the audit and its link to the auditor providing an opinion based on obtaining reasonable assurance by obtaining sufficient appropriate audit evidence. The definition of reasonable assurance could then be included in this section. We also believe it would be helpful to include footnote 2, which explains the different forms of opinion on compliance and fair presentation frameworks, in this separate section. This section could be titled, 'purpose of the audit.'

We would therefore suggest that the section, 'overall objective of the independent auditor', should only include paragraph 5 suitably amended to focus on the main objective of the auditor's work, which is the expression of the

¹ ED, paragraph 1

auditor's opinion. A suggested, revised, paragraph 5 could be something as follows:

'In conducting an audit of financial statements, the overall objective of the auditor is to express an opinion on the financial statements based on obtaining reasonable assurance:

- (i) whether the financial statements as a whole are free from material misstatement, whether due to fraud or error; and
- (ii) are prepared in all material respects, in accordance with the applicable financial reporting framework.'

Paragraph 6 could be better located at the end of the requirements section as it deals with the actions to be taken if the auditor fails to achieve the overall objective.

Preparation of the financial statements

Paragraph 7 – for clarity, for non-English speakers, change the words 'premised on the fact' to 'based on the assumptions'.

An Audit of Financial Statements, and Related Concepts

We are not convinced, for reasons noted in the next few paragraphs, that much of this section adds to the clarity of the ED, and would suggest that the IAASB investigate, in particular, whether the concepts section is necessary as the concepts could be covered under the definitions (indeed some are noted there already) and the associated application material could be linked to these definitions.

Paragraphs 9 & 10 – these do not seem to be necessary if there was a separate section covering the purpose of the audit as noted above.

Paragraph 13 (d) – **Professional judgement**. This is linked to the discussion of professional judgement in A 24 and A 25. There is also some discussion of professional judgement in A 54. Though we appreciate the IAASB's point that 'professional judgement is something that can be challenged' (Explanatory memorandum, p 8), we still have some concerns about the placing of references to and description of professional judgement as laid out in A 25 in particular. The emphasis seems to be to a very great extent on the 'judgement' aspect e.g. it is a 'personal quality'; it may 'differ between experienced auditors', rather than on the 'professional' aspect. We would suggest that the emphasis in professional judgement should be on 'reasonable professional judgement'.

We appreciate that auditing standards cannot and should not be drafted to deal with all possible scenarios that an auditor might face in an audit. Appropriate professional judgement needs to be exercised when setting levels of materiality, evaluating whether there is sufficient audit evidence and, in particular, evaluating management's judgements in applying the entity's applicable financial reporting framework. However, on the other hand, it should not be possible to use the phrase 'professional judgement' as a justification where there has been insufficient audit work. It should be clear in the ED that professional judgement should mean 'reasonable professional judgement' in the particular facts and circumstances.

The last two sentences of A 25 seem to summarise this better than the first sentence in A 25. We would suggest that the first sentence of A 25 be omitted.

Otherwise, the exercise of professional judgement could be used as an excuse for deficient auditing (e.g. the achievement of objectives under A 54) where the auditor made personal (but not appropriate professional) judgements which differed materially from those which would be made by appropriately experienced auditors.

Paragraph 13 (e) **Professional scepticism**. There is a discussion of professional scepticism in paragraphs 18, A 26, A 27 & A 42. However, not all these paragraphs convey the same message about this key concept. For example, A 26 states that the auditor should be alert to contradictory evidence (a key point, we would argue), while A 42 does not. We would suggest that the discussion about professional scepticism in the different paragraphs be aligned and located in one place within the ISA so that there is a consistent message.

Paragraph 13(f) **Inherent limitations of an audit**. We are not convinced that 'inherent limitations of an audit' is a concept underlying the audit. We believe that much of this discussion is really about what is often called 'the audit expectation gap' and is an issue of communication rather than a concept. We accept that there should be some discussion of the issue in this ED, but are concerned that the current discussion is so extensive and excessively negative about what is possible with an audit, that it may not set an appropriately high standard for what the auditor can achieve. This is demonstrated by the substantial discussion on the inherent limitations of an audit in A 28-A 40. We believe that some of this discussion is unnecessary and some may not be correct.

Separately, we also note in this context, the discussion of detection risk in A 19, where it is stated that 'detection risk cannot be reduced to zero because of the inherent limitations of an audit'. As far as we are aware, detection risk is composed of sampling risk (the risk the sample is not representative of the population) and quality control risk (the risk the auditor fails to obtain sufficient appropriate audit evidence and/or to evaluate it properly). Therefore it is not strictly linked to the inherent limitations of the audit, but to a greater extent to the quality of the auditor's work. This should be clarified.

A 29 covers the 'audit expectations gap', which we believe is appropriate. However, it is not strictly speaking an 'inherent limitation' of the audit, but a statement about what the audit is not. We also note that the second bullet point in this paragraph which covers that an auditor does not express an opinion on internal control, has been expanded to include in brackets, 'including the effectiveness of internal control.' We appreciate that this statement is correct for an audit conducted under ISAs, but would suggest that the ED should also include some application material to highlight that in some jurisdictions, the auditor may also be providing a separate opinion on the effectiveness of internal control.

A 31 states in its last sentence, that 'inherent limitations, by their nature, cannot be overcome.' We note above and below in this letter some of our concerns about what has been included in 'inherent limitations' but would also note that, for those inherent limitations that are appropriate, to say 'they cannot be overcome', is not correct. It is that 'they cannot be completely overcome.'

The discussion of inherent limitations of the audit in relation to financial reporting and business processes in paras A 32 and A33 actually deals with the 'inherent risk' relating to the specific audit. The auditor seeks to deal with this

inherent risk through the design of the audit tests, for example by reducing the likely detection risk. Much of the discussion in paras A 32 and A 33 is not, off itself, an inherent limitation of the audit itself, but concerns general limitations of financial reporting and systems of internal controls. We also note, in para A 32, that the discussion of fair value as an example should not refer to fair values generally, but could refer to certain fair values based on models or entity specific values.

We accept that there should be a discussion of the inherent limitations of an audit, conducted to obtain reasonable assurance, in ISA 200. However, we suggest that the current discussion is amended to deal with our concerns above, and is then simplified to cover the key aspects:

- Paragraph A 28 (amended to exclude the discussion on financial reporting and business processes)
- Paragraphs A34-A 40 which are important as they cover the nature of audit evidence and the balance between cost and benefit.

Paragraphs A32 & A33 should be omitted from the coverage of inherent limitations of an audit.

A 29 (amended as noted above) should be included in the ED, though we are unsure if this section is the appropriate location.

Requirements

Paragraph 17 – we believe it would simplify the ED if paragraphs 14 & 15, which cover auditor independence, were included in this section of the ISA, either as essential guidance or as application material.

Paragraph 18 – see above re professional scepticism

Paragraph 20 – and paragraph 11 – describes the relationship between the ISAs and the objectives in a way that is slightly different from that covered in A 43. We would suggest they should be aligned to convey the same message i.e. that the ISAs, taken together, are designed to enable the auditor to achieve his/her overall objective.

Paragraph 21 – we are not convinced that the second sentence of this paragraph is necessary as there is plenty of coverage of ‘professional judgement’ elsewhere in the ED.

Paragraph 23 – this essential guidance is not as clear as that which is set out in A 53. We would suggest that A 53 replaces paragraph 23.

Paragraph 24 – we are concerned about the message conveyed by the sentence in the paragraph that, ‘the proper application of the requirements of the ISAs will ordinarily provide a sufficient basis for the auditor’s achievement of the objectives’.

The requirements included in each ISA are those that are ‘expected to be applicable in virtually all engagements to which the Standard is relevant’² Therefore it is likely in many of the more complex or specialist audits e.g. for banks, that application of the requirements on their own will not be sufficient to achieve the objectives. We therefore suggest that this element of the sentence in paragraph 24 is deleted.

² One of the criteria set by the IAASB for determining the requirements of a Standard

Paragraph 25 – rather than ‘shall consider’ it should be ‘shall evaluate’ as that is what the auditor would have to do.

Application and Other Explanatory Material

See comments above on relevant paragraphs