

STATEMENT OF AUDITING STANDARDS
100
OBJECTIVE AND GENERAL PRINCIPLES
GOVERNING AN AUDIT OF FINANCIAL STATEMENTS

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Auditors are required to comply with the requirements of this SAS in respect of audits of financial statements for periods beginning on or after 15 December 2004. Early application of the provisions of this SAS is permissible.

Auditors are required to comply with the requirements in paragraphs 1 to 15 and 29 of this SAS in respect of audits of financial statements for periods beginning before 15 December 2004.

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OBJECTIVE AND GENERAL PRINCIPLES
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*Statements of Auditing Standards (SASs) are to be read in the light of SAS 010 "The scope and authority of auditing pronouncements". In particular, they contain basic principles and essential procedures, (auditing standards), indicated by paragraphs in **bold italic type**, with which auditors are required to comply in the conduct of any audit including those of companies applying section 141D of the Companies Ordinance. SASs also include explanatory and other material which is designed to assist auditors in interpreting and applying auditing standards.*

Introduction

1. The purpose of this Statement of Auditing Standards (SAS) is to establish standards and provide guidance on the objective and general principles governing an audit of financial statements.

Objective of an audit

2. *The objective of an audit of financial statements is to enable auditors to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework. (SAS 100.1)*
3. The phrase normally used to express the auditors' opinion is "give a true and fair view". The financial reporting framework adopted may be accounting principles generally accepted in Hong Kong, International Accounting Standards or other comprehensive basis of accounting.
4. Although the auditors' opinion enhances the credibility of the financial statements, users cannot assume that the opinion is an assurance as to the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity.

General principles of an audit

5. *Auditors should comply with the Statements of Professional Ethics issued by the Hong Kong Institute of Certified Public Accountants. (SAS 100.2)*
6. Ethical principles governing auditors' professional responsibilities are:
 - a. independence;
 - b. integrity;
 - c. objectivity;
 - d. professional competence and due care;
 - e. confidentiality;
 - f. professional behaviour; and
 - g. technical standards.

7. *Auditors should conduct an audit in accordance with SASs or, where an audit is being carried out of an overseas enterprise for purposes other than Hong Kong reporting, the audit should conform to appropriate standards as set out in paragraph 16 of SAS 010 "The scope and authority of auditing pronouncements". (SAS 100.3)*
8. SASs contain basic principles and essential procedures together with related guidance in the form of explanatory and other material.
9. *Auditors should plan and perform an audit with an attitude of professional scepticism recognising that circumstances may exist which cause the financial statements to be materially misstated. (SAS 100.4)*
10. An attitude of professional scepticism means the auditors make a critical assessment, with a questioning mind, of the validity of audit evidence obtained and are alert to audit evidence that contradicts or brings into question the reliability of documents or management representations. For example, an attitude of professional scepticism is necessary throughout the audit process for the auditors to reduce the risk of overlooking suspicious circumstances, of overgeneralizing when drawing conclusions from audit observations, and of using faulty assumptions in determining the nature, timing and extent of the audit procedures and evaluating the results thereof.

In planning and performing an audit, the auditors neither assume that management is dishonest nor assume unquestioned honesty. Accordingly, representations from management are not a substitute for obtaining sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.

Scope of an audit

11. *The procedures required to conduct an audit in accordance with SASs should be determined by the auditors having regard to the requirements of SASs, legislation, regulations and, where appropriate, the terms of the audit engagement and reporting requirements. (SAS 100.5)*

Reasonable assurance

12. An audit in accordance with SASs is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement. The view given in financial statements is derived from a combination of fact and judgement, and consequently cannot be characterised as "absolute". When reporting on financial statements, therefore, auditors provide a level of assurance which is reasonable in that context but, equally, cannot be absolute.
13. However, there are inherent limitations in an audit that affect the auditors' ability to detect material misstatements. These limitations result from factors set out below.
 - a. The impracticality of examining all items within an account balance or class of transactions.
 - b. The inherent limitations of any accounting and internal control system (for example, the possibility of collusion).
 - c. The fact that most audit evidence is persuasive rather than conclusive.
14. Also the work undertaken by auditors to form an opinion is permeated by judgement, in particular regarding:
 - a. the gathering of audit evidence, for example, in deciding the nature, timing and extent of audit procedures; and
 - b. the drawing of conclusions based on the audit evidence gathered, for example, assessing the reasonableness of the estimates made by management in preparing the financial statements.

15. Further, other limitations may affect the persuasiveness of evidence available to draw conclusions on particular financial statement assertions (for example, transactions between related parties). In these cases certain SASs identify specified procedures which, because of the nature of the particular assertions¹, provide sufficient appropriate audit evidence in the absence of:
 - a. unusual circumstances which increase the risk of material misstatement beyond that which would ordinarily be expected; or
 - b. any indication that a material misstatement has occurred.
16. Accordingly, because of the factors described above, an audit is not a guarantee that the financial statements are free of material misstatement.

Audit Risk and materiality

17. Entities pursue strategies to achieve their objectives, and depending on the nature of their operations and industry, the regulatory environment in which they operate, and their size and complexity, they face a variety of business risks². Management is responsible for identifying such risks and responding to them. However, not all risks relate to the preparation of the financial statements. The auditors are ultimately concerned only with risks that may affect the financial statements.
18. The auditors obtain and evaluate audit evidence to obtain reasonable assurance about whether the financial statements give a true and fair view in accordance with the applicable financial reporting framework. The concept of reasonable assurance acknowledges that there is a risk the audit opinion is inappropriate. The risk that the auditors express an inappropriate audit opinion when the financial statements are materially misstated is known as "audit risk"³.
19. ***The auditors should plan and perform the audit to reduce audit risk to an acceptably low level that is consistent with the objective of an audit. (SAS 100.6)***
20. The auditors reduce audit risk by designing and performing audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base an audit opinion. Reasonable assurance is obtained when the auditors have reduced audit risk to an acceptably low level.
21. Audit risk is a function of the risk of material misstatement of the financial statements (or simply, the "risk of material misstatement") (*i.e.*, the risk that the financial statements are materially misstated prior to audit) and the risk that the auditors will not detect such misstatement ("detection risk"). The auditors perform audit procedures to assess the risk of material misstatement and seek to limit detection risk by performing further audit procedures based on that assessment (see SAS 315 "Understanding the entity and its environment and assessing the risks of material misstatement" and SAS 330 "The auditor's procedures in response to assessed risks"). The audit process involves the exercise of professional judgement in designing the audit approach, through focusing on what can go wrong (*i.e.*, what are the potential misstatements that may arise) at the assertion level (see SAS 500 "Audit evidence") and performing audit procedures in response to the assessed risks in order to obtain sufficient appropriate audit evidence.

¹ Paragraphs 15 - 18 of SAS 500 "Audit evidence" discuss the use of assertions in obtaining audit evidence.

² Paragraphs 30 - 34 of SAS 315 "Understanding the entity and its environment and assessing the risks of material misstatement," discuss the concept of business risks and how they relate to risks of material misstatement.

³ This definition of audit risk does not include the risk that the auditors might erroneously express an opinion that the financial statements are materially misstated.

22. The auditors are concerned with material misstatements, and are not responsible for the detection of misstatements that are not material to the financial statements taken as a whole. The auditors consider whether the effect of identified uncorrected misstatements, both individually and in the aggregate, is material to the financial statements taken as a whole. Materiality and audit risk are related (see SAS 220 "Audit materiality"). In order to design audit procedures to determine whether there are misstatements that are material to the financial statements taken as a whole, the auditors consider the risk of material misstatement at two levels: the overall financial statement level and in relation to classes of transactions, account balances, and disclosures and the related assertions⁴.
23. The auditors consider the risk of material misstatement at the overall financial statement level, which refers to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature often relate to the entity's control environment (although these risks may also relate to other factors, such as declining economic conditions), and are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Rather, this overall risk represents circumstances that increase the risk that there could be material misstatements in any number of different assertions, for example, through management override of internal control. Such risks may be especially relevant to the auditors' consideration of the risk of material misstatement arising from fraud. The auditors' response to the assessed risk of material misstatement at the overall financial statement level includes consideration of the knowledge, skill, and ability of personnel assigned significant engagement responsibilities, including whether to involve experts; the appropriate levels of supervision; and whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.
24. The auditors also consider the risk of material misstatement at the class of transactions, account balance, and disclosure level because such consideration directly assists in determining the nature, timing, and extent of further audit procedures at the assertion level⁵. The auditors seek to obtain sufficient appropriate audit evidence at the class of transactions, account balance, and disclosure level in such a way that enables the auditors, at the completion of the audit, to express an opinion on the financial statements taken as a whole at an acceptably low level of audit risk. Auditors use various approaches to accomplish that objective⁶.
25. The discussion in the following paragraphs provides an explanation of the components of audit risk. The risk of material misstatement at the assertion level consists of two components as follows:

⁴ SAS 315 "Understanding the entity and its environment and assessing the risks of material misstatement" provides additional guidance on the auditors' requirement to assess risks of material misstatement at the financial statement level and at the assertion level.

⁵ SAS 330 "The auditor's procedures in response to assessed risks" provides additional guidance on the requirement for the auditors to design and perform further audit procedures in response to the assessed risks at the assertion level.

⁶ The auditors may make use of a model that expresses the general relationship of the components of audit risk in mathematical terms to arrive at an appropriate level of detection risk. Some auditors find such a model to be useful when planning audit procedures to achieve a desired audit risk though the use of such a model does not eliminate the judgement inherent in the audit process.

- "Inherent risk" is the susceptibility of an assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there are no related controls. The risk of such misstatement is greater for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, complex calculations are more likely to be misstated than simple calculations. Accounts consisting of amounts derived from accounting estimates that are subject to significant measurement uncertainty pose greater risks than do accounts consisting of relatively routine, factual data. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement. In addition to those circumstances that are peculiar to a specific assertion, factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may influence the inherent risk related to a specific assertion. These latter factors include, for example, a lack of sufficient working capital to continue operations or a declining industry characterized by a large number of business failures.
 - "Control risk" is the risk that a misstatement that could occur in an assertion and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control. That risk is a function of the effectiveness of the design and operation of internal control in achieving the entity's objectives relevant to preparation of the entity's financial statements. Some control risk will always exist because of the inherent limitations of internal control.
26. Inherent risk and control risk are the entity's risks; they exist independently of the audit of the financial statements. The auditors are required to assess the risk of material misstatement at the assertion level as a basis for further audit procedures, though that assessment is a judgement, rather than a precise measurement of risk. When the auditors' assessment of the risk of material misstatement includes an expectation of the operating effectiveness of controls, the auditors perform tests of controls to support the risk assessment. The SASs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risk of material misstatement". Although the SASs ordinarily describe a combined assessment of the risk of material misstatement, the auditors may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risk of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditors to make appropriate risk assessments is more important than the different approaches by which they may be made.
27. "Detection risk" is the risk that the auditors will not detect a misstatement that exists in an assertion that could be material, either individually or when aggregated with other misstatements. Detection risk is a function of the effectiveness of an audit procedure and of its application by the auditors. Detection risk cannot be reduced to zero because the auditors usually do not examine all of a class of transactions, account balance, or disclosure and because of other factors. Such other factors include the possibility that auditors might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results. These other factors ordinarily can be addressed through adequate planning, proper assignment of personnel to the engagement team, the application of professional scepticism, and supervision and review of the audit work performed.
28. Detection risk relates to the nature, timing, and extent of the auditors' procedures that are determined by the auditors to reduce audit risk to an acceptably low level. For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessment of the risk of material misstatement at the assertion level. The greater the risk of material misstatement the auditors believe exists, the less the detection risk that can be accepted. Conversely, the less risk of material misstatement the auditors believe exist, the greater the detection risk that can be accepted.

Responsibility for the financial statements

29. While auditors are responsible for forming and expressing an opinion on the financial statements, the responsibility for preparing and presenting the financial statements is that of the management of the entity. The audit of the financial statements does not relieve management of its responsibilities.

Compliance with International Standards on Auditing

30. Compliance with the auditing standards contained in this SAS ensures compliance in all material respects with the basic principles and essential procedures in International Standard on Auditing 200 "Objective and General Principles Governing an Audit of Financial Statements".

Effective date

31. Auditors are required to comply with the requirements of this SAS in respect of audits of financial statements for periods beginning on or after 15 December 2004. Early application of the provisions of this SAS is permissible.
32. Auditors are required to comply with the requirements in paragraphs 1 to 15 and 29 of this SAS in respect of audits of financial statements for periods beginning before 15 December 2004.