Auditor’s Report on Financial Statements

Objectives of Agenda Item
To review and approve exposure draft wording of the proposed revised ISA 700, The Independence Auditor’s Report on General Purpose Financial Statements and related conforming amendments to:

- ISA 200, Objectives and General Principles Governing an Audit of Financial Statements
- ISA 210, Terms of Audit Engagements
- ISA 560, Subsequent Events
- ISA 580, Management Representations
- ISA 701, Modifications to the Independent Auditor’s Report
- ISA 800, The Auditor’s Report on Special Purpose Audit Engagements

Background
IAASB approved the commencement of the project to revise ISA 700, The Auditor’s Report on Financial Statements, at the June 2002 meeting in Mexico City, with the aim to have revisions to ISA 700 approved and in place by January 2005.

IAASB discussed the Task Force’s preliminary recommendations on the key issues identified in the project proposal and provided input and suggestions for further consideration at its meetings in December 2002, March 2003 and May 2003. The Board, the IAASB Consultative Advisory Group and other stakeholders, including meetings of European national auditing standard setters, also provided input on proposed revisions to wording of the auditor’s report.

In July, the Board discussed a first draft of the proposed Exposure Draft wording and provided comments to the Task Force for further consideration.

Activities Since Last IAASB Discussions
Since the July IAASB meeting, the Task Force has had a two-day meeting in London and a conference call to consider and respond to IAASB’s comments and to prepare revised draft wording of the Exposure Draft. To demonstrate how the Task Force has responded to the comments received, a mark-up has been included in each agenda paper showing the changes that the Task Force has made to the wording presented in July. Given the number of agenda papers in this series, the mark-up is attached to the clean copy of each ISA rather than being included separately.

The Task Force believes that it has been able to respond to the comments received and recommends that IAASB approve the revised versions for exposure.
ISA 700 and ISA 800
At the July meeting of the IAASB, it was agreed that the ISA 700 Task Force would give further consideration to the question of what should fall within the scope of ISA 700 and ISA 800. The discussion below summarises the conclusions of the Task Force. At the heart of the matter is what constitutes general and special purpose financial statements.

General purpose financial statements
It was clear from the discussion in July that there exists a range of views on what falls within "general purpose", in particular that a single financial statement (eg a balance sheet) could, in the opinion of a number of IAASB members, be designated as general purpose. The Task Force has debated this, and has determined that the best definition to use is the IASB definition, which states that general purpose financial statements are those that are intended to fulfil the financial information needs of a wide range of users. It follows from this that only a full set of financial statements, including footnotes, can meet the "wide range of users" test, on the grounds that no-one, be they legislator, regulator or auditor, can judge what might be the perspective of one user compared to another. The fact that a single statement may be made available to a large number of users is not the deciding factor in the debate; distribution is a separate issue.

Special purpose financial statements
Any financial statements that are not "complete" (ie a full set) do not fall within the definition of general purpose, and consequently fall into the "special purpose" category. When ISA 800 is revised (clearly this is a priority now), further thought will need to be given to the question of what forms of wording will be appropriate for such reports, but under the existing ISA 800, the use of "presents fairly" or "true and fair" is not precluded. The Task Force believes that, however contentious the reporting issue may be, it should not cause the distinction between general and special purpose to be blurred, a compromise that would not serve our constituencies, or the public interest, well.

Task Force’s recommendation
Although the IASB definition of general purpose may be subject to some debate, it would be confusing and even misleading for IAASB to adopt anything different, and the treatment proposed by the Task Force has the merit of logic and clarity.

Effective dates
In preparing the Exposure Draft, the Task Force asked the IAASB Technical Director and technical staff for advice on the appropriate effective dates for ISA 700 and related conforming amendments.

The effective dates for most ISAs are based on the date on which the engagement commences (e.g., “This ISA is effective for audits of financial statements for periods ending on or after December 31, 2000”). This makes sense when the ISAs specific engagement performance requirements, as the new requirements can be taken into account from the beginning of the engagement. It may, however, not be an appropriate approach for an ISA that will change the wording of the auditor’s report. The downside of relating the effective date to the beginning of the engagement for new wording of the auditor’s report is that it would result in two styles of reports in the marketplace simultaneously (as engagements will begin at different dates and may cover different periods of time). For this reason, it may be preferable to have all audit reports change at a particular point in time so that the transition from one style of report to the other is clean and quick.

As a general rule, national auditing standards tend to use different approaches to effective dates for standards influencing engagement performance and standards influencing the report.
The following discussion represents the views of IFAC Technical Staff on the approach that should be adopted in the revision to ISA 700:

The main interest must be to limit confusion in the public eye caused by having two styles of reports in the marketplace simultaneously.

There are two options:

**ISA 700 to be applied for all financial statements beginning on or after a defined date**

The Audit Risk ISAs will be proposing that those standards be effective for financial periods beginning on or after December 15, 2004 with earlier application either permitted or encouraged. (To be determined by the IAASB).

If this ISA is applied for reports on financial periods beginning on or after December 15, 2004 then all reports would be related to audits done in accordance with the new risk standards and the “understanding” of the entity referred to in the report would be the same as that acquired in accordance with the risk standards. Thus performance and reporting would be in sync.

There are, however, two problems. First, the marketplace would be confused by an audit firm which might issue two audit reports on the same day – say February 2006. One would be on the financial statements of a client with a November 30, 2005 yearend and be in the “old” style and the other on a client with a December 31, 2005 year end and be in the “new” style. Second, an auditor auditing financial statements for the year ended November 30, 2005 may choose to apply the new risk standards. Does that require the “new” style report or the “old” style report? In our view issuing the old report is not wrong – even if the wording of the new report is clearer.

**ISA 700 to be applicable for audit reports dated on or after December 15 (or 31) 2005.**

This option should be linked with a prohibition from earlier application.

This would have the benefit of ensuring that all reports of 2005 annual statements would be accompanied by the “new” report.

There are, however, two potential problems. First, audits of periods ending before December 15, 2005 (e.g. September 30, 2005) might be done in accordance with the “new” risk standards and receive an old style report if dated before December 15, 2005. Second, audits for September 30, 2005 might be done in accordance with the “old” risk standards but the report not completed or dated until January 2006 – whereupon the new form of report would need to be applied even if the audit had followed the “old” standards.

We see no problem in issuing an old style report even if the audit has been conducted in accordance with new standards. The report is not wrong!

The downside risk under this option is that auditors need to aware that annual audits for periods ending in September – December 14, 2005 might not be completed by December 31, 2005 and therefore would need to be planned using the new risk standards. A particular risk arises if an audit was properly planned to be completed by December 15, 2005 but due to unforeseen circumstances the report cannot be dated before January 2006. One way of limiting this problem is to advance the application date to March 2006. This reduces the risk of this situation problem arising but on the other hand would result in many December 31, 2005 audits which would have reports issued in January, February or March 2006 having to follow the old style report. Further, we think the EU would find it unacceptable to have an implementation date so far in the future.

We therefore recommend that the ED proposes that the new standard should be effective for audit reports dated on or after December 31, 2005 and that earlier application not be permitted. We would
further propose that the application of the conforming amendments to ISA 560 and 580 should similarly be linked to the audit report date.

Finally we recommend that the Preface to the ED contains a specific question to respondents seeking views on the application date.

**Material Presented**

**Agenda Item 3-A (Pages 1237-1258)**
- Proposed revisions to ISA 200, *Objective and General Principles Governing an Audit of Financial Statements*

Note that this Agenda Paper incorporates the proposed wording for the section on Audit Risk and Materiality as presented by the Audit Risk Task Force. The mark-up showing the proposed changes to the Exposure Draft wording for this section is included in the Audit Risk agenda papers.

**Agenda Item 3-B (Pages 1259-1264)**
- Proposed revisions to ISA 210, *Terms of Audit Engagements*

**Agenda Item 3-C (Pages 1265-1296)**
- Proposed new ISA 700, *The Independent Auditor’s Report on General Purpose Financial Statements*

**Agenda Item 3-D (Pages 1297-1302)**
- Proposed new ISA 701, *Modifications to the Independent Auditor’s Report*

**Agenda Item 3-E (Pages 1303-1312)**
- Proposed revisions to ISA 560, *Subsequent Events*

**Agenda Item 3-F (Pages 1313-1314)**
- Proposed revisions to ISA 580, *Management representations*

**Agenda Item 3-G (Pages 1315-1316)**
- Proposed revisions to ISA 800, *The Auditor’s Report on Special Purpose Audit Engagements*

**Action Requested**

IAASB is asked to review and consider whether the Board is prepared to approve as an Exposure Draft the proposed new ISA 700 and ISA 701, together with the proposed conforming amendments to ISAs 200, 210, 560, 580 and 800. Any editorial comments should be forwarded to the Task Force in advance of the meeting.