Committee: IAASB  
Meeting Location: Berlin  
Meeting Date: 8-12 December 2003  

Auditor’s Report on Financial Statements

Objectives of Agenda Item
To review and approve exposure draft wording of the proposed revised ISA 700, *The Independent 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 701, *Modifications to the Independent Auditor’s Report*
- ISA 800, *The Independent 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.

The Board, the IAASB Consultative Advisory Group and other stakeholders, including European national auditing standard setters, have provided input on issues relating to the project. These groups have also provided comments on earlier versions of the proposed wording of the auditor’s report.

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

Activities Since Last IAASB Discussions

IAASB CONSULTATIVE ADVISORY GROUP MEETING
Philip Ashton discussed the current proposed wording of the auditor’s report with CAG at its meeting 6-7 November in Brussels.

CAG had already been directed to the Agenda Papers presented to IAASB for the Tokyo meeting as background for the discussion of this topic at the CAG meeting and, to bring them up to date, members were given a brief overview of the significant changes proposed to the October agenda papers as a result of the Board’s discussions in Tokyo. CAG’s views were also specifically sought on the two matters on which there was considerable discussion in Tokyo:
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• Whether the description of management’s responsibilities should include management’s responsibility with respect to internal control and, if so, whether flexibility should be allowed in that description to allow for jurisdictional differences in management’s responsibilities.

• Whether the auditor’s report should explain the parameters around the scope of the auditor’s responsibilities with respect to internal control and, if so, whether the proposed description was appropriate (the version discussed on Friday in Tokyo which does not elaborate on the auditor’s responsibilities to communicate material weaknesses in controls to management and those charged with governance).

CAG members believed that it is very important to discuss both management's and the auditor's responsibilities for internal control. CAG members believed it should be possible to have a generic description. Although CAG appreciated that the precise description of management's responsibilities differ in different jurisdictions, they believed that the audit report wording should be consistent and that it should be possible to draft a generic principle statement regarding management's responsibility for internal control.

CAG continues to express strong support for the project and the direction it is taking. The 700/800 split was not of particular concern to CAG members, however, the EC representatives commented that it is important that the concepts of "general purpose" and "complete set" be clear.

OTHER TASK FORCE ACTIVITIES
Following the Tokyo meeting, IAASB members were invited to provide additional comments to the Task Force and the Task Force received a number of very useful comments and suggestions.

The drafting team analysed the comments received from both CAG and IAASB members and prepared revised drafts, which were discussed by the Task Force in a conference call 12 November.

In addition to mark-ups of the ISAs, the Task Force has also prepared a copy of the Exposure Draft. While there has not yet been sufficient time to fully draft the Explanatory Memorandum, a tentative outline of its contents is provided. The Task Force will continue working on the wording so that it is ready prior to the Berlin meeting for IAASB’s consideration.

The Task Force has used its best efforts to faithfully respond to the comments received. The significant changes are summarised below. Overall, the Task Force believes that the changes made both in Tokyo and subsequent to the Tokyo meeting significantly improve the Exposure Draft wording and is appreciative of all of those who have provided constructive comments. It is the Task Force’s hope that IAASB will share the view that substantial progress has been made and approve the revised versions for exposure.

**Significant Changes Since Tokyo**

**CLARIFYING THE ISA 700/800 SPLIT**

*Issues Identified by IAASB*

In Tokyo, a significant amount of discussion was devoted to the split between which audit reports would be addressed in ISA 700 versus ISA 800. The proposed split was as follows:
The proposed guidance in ISA 700 was written from the perspective of an audit of general purpose financial statements designed to present the financial position, financial performance and cash flows of an entity (consistent with IFRS).

The following comments/concerns were raised by IAASB during the meeting and/or subsequent to the meeting:

- The proposals do not clearly explain the above split and why it is necessary.
- There should be no ambiguity as to whether something is in ISA 700 or in ISA 800.
- ISA 200 should set the path for the ISA 700/800 split.
- The proposed split could change existing practice in jurisdictions where auditors express a “presents fairly/true and fair” opinion on an individual financial statement that is a component of a complete set of financial statements (such as a balance sheet only for a profit-oriented enterprise). Although the illustrative report in ISA 800 uses this wording of the auditor’s opinion at present, there remains uncertainty because of the planned project to revise it.

**Task Force Deliberations**

The proposed material in the agenda papers does not change the actual split between ISA 700 and 800.

The Task Force believes that it is still appropriate for ISA 700 to deal with reporting on a complete set of general purpose financial statements as required by an applicable financial reporting framework and for ISA 800 to address the special considerations when the financial reporting framework is not complete.

The Task Force believes that reporting on a single financial statement that is a component of a complete set of financial statements belongs in ISA 800 because there are additional matters the auditor needs to consider in such engagements (as explained in more detail below).

The Task Force recognizes the concerns relating to possible changes in practice with respect to the auditor’s opinion when reporting on a balance sheet only. However, the Task Force firmly believes that this issue is outside the scope of this project. There are different reporting practices in such circumstances in different jurisdictions around the world today and it is an issue that needs to be debated and discussed as part of the revisions to ISA 800. Until ISA 800 is clarified, the guidance and illustrative examples in ISA 800 enable auditors to continue the practices they have followed.

To address the other comments raised by IAASB, the material has been revised to:

- Clarify the meaning of a complete set of financial statements. ISA 200 now states that the requirements of the financial reporting framework will determine what constitutes a complete set of financial statements. It also explains that for certain financial reporting frameworks, a single financial statements.
statement such as a cash flow statement and the related explanatory notes constitutes a complete set of financial statements. The International Public Sector Accounting Standards are given as an example of this situation (they state that the primary financial statement is the cash flow statement when the cash basis of accounting underlies the preparation of the financial statements).

- **Clarify the ISA 700/800 split.** ISA 200 has been expanded to include a section on expressing an opinion on the financial statements (see paragraphs 45 to 47) which provides a “roadmap” that states that the auditor looks to:
  - ISA 700 when expressing an opinion on a complete set of general purpose financial statements, as defined by the applicable financial reporting framework.
  - ISA 800 when expressing an opinion on a complete set of financial statements prepared in accordance with a financial reporting framework designed for a special purpose and on a component that is less than a complete set of financial statements such as a single financial statement, specified accounts, elements of accounts, or items in a financial statement.

- **Address the question of why it is necessary for ISA 800 to address less than a complete set of general purpose financial statements.** ISA 200 has been expanded (see paragraph 47) to explain that, in addition to addressing reporting considerations, ISA 800 addresses other relevant matters related to, for example, engagement acceptance and the conduct of the audit. For example, ISA 800 discusses considering restricting the use and distribution of the report when it is a special purpose engagement. ISA 800 also provides guidance on considerations in these types of engagements beyond those in the ISAs, for example, emphasizing that, when reporting on a component of a complete set of financial statements, the auditor considers materiality in relation to the component and the need for the scope of the engagement to take into account other interrelated financial statement items that could materially affect the information on which the opinion is to be expressed.

**APPLICABLE FINANCIAL REPORTING FRAMEWORK**

As a result of the discussion in Tokyo, the Task Force reviewed the guidance on applicable financial reporting frameworks that are presumed to be acceptable for general purpose financial statements in ISA 200, 210 and 700 with a view to simplifying and clarifying the guidance. A number of changes have been made with that objective in mind (see paragraphs 35-44 in ISA 200, paragraphs 20-28 in ISA 210 and paragraph 7 in ISA 700).

**WORDING OF THE AUDITOR’S REPORT**

The main concerns regarding the wording of the auditor’s report at the Tokyo meeting focused on the descriptions of both management’s and the auditor’s responsibilities—in particular, the descriptions of their respective responsibilities with respect to internal control. Unease was also expressed regarding the description of the audit process, in particular the wording that had been added to try to reflect the new risk assessment process.

Following the Board meeting, the Task Force received some suggestions from IAASB members/technical advisors for the wording of management’s and the auditor’s responsibilities. The Task Force used the proposed alternative wording as a platform for reflecting on and challenging the wording of the existing report and the various iterations since then. After careful consideration, the Task Force is recommending the following changes to the wording:
Eliminate the use of bullets. Although the Task Force believes that, in some ways, the use of bullets improves the readability of the report, they increase its length and the report looks better overall when they are removed.

Use neutral wording to describe the relevant internal controls in both the auditor’s and management’s responsibilities. In Tokyo, it had been suggested that “internal control” be modified by “over financial reporting”. While this is the description that will be used for SEC registrants under Sarbanes-Oxley, it differs significantly from the scope of management’s responsibilities for internal in other countries (for example, in the UK, directors are responsible for the effectiveness of the company’s financial, operating and compliance controls and risk management). But, perhaps even more significantly, there is no “hook” in the ISA auditing literature for that term. In the new ISA 315, the only reference to “financial reporting” in the discussion of internal control is in the context of business processes – which is only one of the five elements of internal control.

For these reasons, the Task Force concluded that it is not appropriate to use the term “internal control over financial reporting” in describing management’s and the auditor’s responsibilities for internal control.

In lieu of that phrase, the Task Force is proposing to use a more descriptive narrative that is based on management’s responsibility for fair presentation of the financial statements – “internal control relevant to the preparation of financial statements that are free of material misstatement, whether due to fraud or error”. This phrasing also has the advantage of retaining the reference to “fraud and error” in respect to management’s responsibilities, which IAASB continued in Tokyo to believe was important.

Defining the boundaries of the auditor’s responsibilities for internal control. The Task Force continues to believe that, as a result of the fact that some, but not all, auditors will be expected to perform an audit of internal controls at the same time as the audit of financial statements, it is important that an ISA auditor’s report explain the limitations in the auditor’s consideration of internal control in an ISA audit. CAG agreed with this view.

There has been continuing debate at IAASB meetings whether that description should include reference to the auditor’s reporting responsibilities when material weaknesses in internal control are identified. One of the suggestions that the Task Force received after the Tokyo meeting was as follows:

An audit includes considering internal control over financial reporting sufficiently to design appropriate audit procedures, but not for the purpose of expressing an opinion on its effectiveness. However, auditing standards require the auditor to communicate any material weaknesses in internal control that come to the auditor’s attention during the course of an audit to management and those charged with governance.

The Task Force carefully considered the above suggestion but decided not to adopt the wording or its proposed placement at the beginning of the description of the audit process.

As noted above, the Task Force believes that the first sentence is useful clarification of the objective (and limitations) of the auditor’s consideration of internal control in an audit of financial statements. The Task Force was concerned, however, that the reference to the auditor’s responsibility to communicate internal control weaknesses in the second sentence could, instead of clarifying matters, lead to more confusion. It may make readers question why the auditor is not communicating
weaknesses to them. It may also make them wonder how the auditor can issue an unqualified opinion on the financial statements when he or she has identified such weaknesses. Therefore, the Task Force concluded that, on balance, it is best not to make reference to the auditor’s additional reporting responsibilities in the auditor’s report.

The Task Force was also concerned about placing these sentences first in the description of the audit process. For many small audits, the auditor may obtain most of the audit evidence through substantive procedures. For those audits, discussing internal control first seems to put an inappropriate over-emphasis on internal controls. As the Task Force is aiming for a generic description of an audit that applies to all audits, the Task Force concluded that the discussion of internal control should be placed later in the description of the audit process.

- **A new approach to the description of the audit.** Building on some of the suggestions of Board members, the Task Force has taken a different approach to the description of what an audit involves – inspired by some of the suggestions Board members offered after the Tokyo meeting. The wording continues to convey a risk approach to the audit, but without using the “coded” language in the ISAs.

- **Linking the conclusion regarding the reasonable basis for the audit to the objective of the audit.** The report says that our responsibility is to express an opinion on the financial statements. To close the loop, it seems appropriate to conclude that we believe that our audit provides a reasonable basis for our opinion on the financial statements.

- **Illustrative examples of legal and regulatory requirements.** In the comments received after the Tokyo meeting, strong concern was expressed about the nature of the illustrative examples of the types of legal and regulatory requirements. While these were real examples of the, admittedly, somewhat archaic requirements in some jurisdictions, the Task Force agreed that it would be best to keep the illustrative report neutral. Including examples might be seen to be endorsing these reporting responsibilities, which was not the intent.

In addition, paragraph 40 of ISA 700 provides further clarification of the nature and scope of additional reporting responsibilities that auditors have in different jurisdictions.

Revisions have also been made to ISA 700 to make the guidance framework neutral, using financial statements prepared in accordance with IFRS as an illustration (consistent with the approach taken in ISA 200). The wording of new paragraphs 10-11 (former paragraph 14) has also been amended as suggested in Tokyo to better explain how different financial reporting frameworks deal with an override and, thereby, management’s responsibilities in circumstances when an override is necessary in order to achieve the objective of fair presentation of the financial statements. The auditor’s overall responsibility—regardless of the framework—remains, however.
Material Presented

Agenda Item 2-A  Proposed Exposure Draft wording (including clean version of text for ISA 700 and mark-up from existing ISA wording for the other ISAs)
(Pages 1789–1834)

The following agenda papers are mark-ups showing changes to the wording presented to IAASB on Friday of the IAASB meeting in Tokyo:

Agenda Item 2-B  Proposed revisions to ISA 200, Objective and General Principles Governing an Audit of Financial Statements
(Pages 1835–1842)

Agenda Item 2-C  Proposed revisions to ISA 210, Terms of Audit Engagements
(Pages 1843–1848)

Agenda Item 2-D  Proposed new ISA 700, The Independent Auditor’s Report on General Purpose Financial Statements
(Pages 1849–1864)

Agenda Item 2-E  Proposed revisions to ISA 800, The Independent Auditor’s Report on Special Purpose Audit Engagements
(Pages 1865–1868)

Agenda Item 2-F  Proposed new ISA 701, Modifications to the Independent Auditor’s Report
(Pages 1869–1870)

Note that a mark-up has not been provided for ISA 560 as no significant changes are proposed to it since Tokyo (other than to conform the quote from IAS 10 to the recently approved revision to it). ISA 560 is included in Agenda Item 2-A.

Agenda Item 2-G  Effective Dates
(Pages 1871–1872)

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, together with the proposed conforming amendments to ISAs 200 and 210 and the proposed conforming amendments to ISAs 560, 701 and 800. Any editorial comments should be forwarded to the Task Force in advance of the meeting.