Agenda Item 5

Committee: IAASB
Meeting Location: Miami
Meeting Date: September 15-19, 2008

ISA 700, “Forming an Opinion and Reporting on Financial Statements”

Objective of Agenda Item
1. To approve as final standard proposed ISA 700 (Redrafted), “Forming an Opinion and Reporting on Financial Statements.”

Task Force
2. The Task Force members are:
   - Diana Hillier – Chair, IAASB Member
   - Sylvia Smith – IAASB Technical Advisor

Activities since Last IAASB Discussions
3. As noted at the June IAASB meeting, significant comments received on the exposure draft of proposed ISA 700 (Redrafted) were discussed at the March 3-4 IAASB Consultative Advisory Group (CAG) meeting. The IAASB CAG Representatives did not have significant comments on the matters highlighted for their consideration. The proposed revised guidance on financial reporting frameworks described by reference to another established framework (see Agenda Item 5-A) will be discussed again at the September 4-5, 2008 IAASB CAG meeting, which may give rise to further comment.

4. The minutes of the June IAASB meeting summarized the comments raised by the IAASB members. Subsequent to the June IAASB meeting, the Task Force considered the comments raised by the IAASB members on June 19 and, in particular, those relating to the guidance on financial reporting frameworks described by reference to another established framework. During July/August, the IAASB members were asked to review the proposed revised guidance. A few responses were received. A compilation of these responses and how the Task Force has dealt with them are set out in Agenda Item 5-D.

5. The proposed ISA in Agenda Item 5-A shows in marked text the proposed changes to the June 19 IAASB draft. Those changes take into account the comments received from IAASB members subsequent to the June IAASB meeting.

Prepared by: Alta Prinsloo (August 2008)

Conforming Amendments to Proposed ISA 700 (Redrafted) as a Result of Proposed ISA 210 (Redrafted)

6. Conforming amendments to proposed ISA 700 (Redrafted) as a result of proposed ISA 210 (Redrafted)\(^2\) are shown in the agenda material relating to proposed ISA 210 (Redrafted). They will be processed to proposed ISA 700 (Redrafted) after they have been agreed with the IAASB.

Matters for Consideration by the IAASB

A. **Financial Reporting Framework Described by Reference to Another Established Framework**

7. At the same time as applying the Clarity conventions to ISA 700 (Amended as a Result of ISA 800 (Revised)),\(^3\) the IAASB proposed that it be amended to address the implications for the auditor’s report of the increasing use of financial reporting frameworks described by reference to, but modified from, International Financial Reporting Standards (IFRS). The proposed amendment, which introduced new guidance on the auditor’s evaluation of whether the financial statements adequately refer to or describe the applicable financial reporting framework, was included in the exposure draft of proposed ISA 700 (Redrafted).

8. The main element of the proposal was that, if the financial reporting framework is described in the financial statements as a modified version of another established framework (e.g., “IFRS as adopted in Jurisdiction X”), the auditor’s evaluation of the adequacy of the description includes consideration of whether the description may be misleading if there is insufficient transparency about the differences between the applicable financial reporting framework and the other established framework. The proposal followed closely the proposed amendment to International Accounting Standard (IAS) 1\(^4\) in the Annual Improvements Exposure Draft of the International Accounting Standards Board (IASB) published in October 2007, though it also sought to generalize the relevant consideration to other frameworks.

9. As reported at the June meeting when the revised draft was discussed, responses to the proposal were mixed. Those who did not support it were concerned that the threshold that would trigger a reporting response was too low and, as a result, would lead to a proliferation of either Emphasis of Matter paragraphs or qualified opinions. In addition, some were concerned that the focus on whether the description “could be misleading” could be interpreted as implying that the underlying financial information in the financial statements (e.g., the entity’s reported financial position, results and cash flows) was misleading; however, this was never the intent. Some were concerned that the proposal would necessitate onerous quantification of the differences, or posed practical difficulties if management did not have an obligation to make such disclosures.

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\(^2\) Proposed ISA 210 (Redrafted) “ Agreeing the Terms of Audit Engagements.”

\(^3\) In October 2006, the IAASB approved the Close Off Document of ISA 800 (Revised), “Special Considerations—Audits of Special Purpose Financial Statements and Specific Elements, Accounts or Items of a Financial Statement” and related conforming amendments in the “old style” (i.e., following the IAASB’s current drafting conventions).

\(^4\) International Accounting Standard (IAS) 1, “Presentation of Financial Statements.”
10. The IAASB debated proposed revised guidance in June. It was noted that the auditor’s evaluation of the adequacy of the description of the applicable financial reporting framework includes consideration whether there is a risk that users may misunderstand the basis on which the financial statements are prepared. If the applicable financial reporting framework is described by reference to another established framework, users may mistakenly assume that the applicable financial reporting framework is the same as, or at least very similar to, the other established framework. If the differences between the applicable financial reporting framework and the other established framework are not significant in the context of the entity’s financial statements, users are unlikely to misunderstand the basis on which the financial statements are prepared. If the differences are significant in the context of the entity’s financial statements, there is a risk that users may misunderstand the basis on which the financial statements are prepared. However, such risk is reduced by being transparent about the applicable financial reporting framework and how it differs from the other established framework.

11. Based on the discussion at the June IAASB meeting, the Task Force revised the proposed guidance to focus on the risk that users may misunderstand the basis on which the financial statements are prepared.

- Paragraphs A11-A12 of Agenda Item 5-A explains the risk of misunderstanding.
- Paragraph A13 of Agenda Item 5-A explains that the risk of misunderstanding is likely to be lower if the differences between the applicable financial reporting framework and the other established framework are likely to be known and understood by intended users since the authorized or recognized standards setting organization, or the relevant legislator or regulator, has identified the differences as part of an established and transparent development process involving deliberation and consideration of the views of a wide range of stakeholders; and the financial statements are likely to be used primarily within the particular jurisdiction. Paragraph A38 indicates that, in such circumstances, if the risk of misunderstanding is in fact low the description of the applicable financial reporting framework is adequate without further explanation.
- Paragraph A14 of Agenda Item 5-A provides examples of how the risk of misunderstanding can be reduced. The first is that management may be able to describe the applicable financial reporting framework without reference to the other established framework; paragraph A38 of Agenda Item 5-A explains that, in these circumstances, the description of the applicable financial reporting framework is adequate without further explanation.
- The other example in paragraph A14 of Agenda Item 5-A of how the risk of misunderstanding might be reduced is that the financial statements may include a description of the differences between the applicable financial reporting framework and the other established framework that are significant in the context of the entity’s financial statements.
- Paragraphs A39 and A40 of Agenda Item 5-A deal with the circumstances where the applicable financial reporting framework has to be described by reference to the other established framework. Paragraph A40 explains that, if the differences between the applicable financial reporting framework and the other established framework are not
significant in the context of the entity’s financial statements, the description of the applicable financial reporting framework without further explanation is likely to be adequate. In this case, intended users are unlikely to misunderstand the basis on which the financial statements are prepared because the financial statements would be substantially the same whether they were prepared in accordance with the applicable financial reporting framework or the other established framework.

- Paragraph A40 of Agenda Item 5-A explains that, if the differences between the applicable financial reporting framework and the other established framework are significant in the context of the entity’s financial statements, the auditor’s evaluation of the adequacy of the description of the applicable financial reporting framework involves consideration of whether the financial statements include a description of the differences. It contains the following examples:
  
  o If the financial statements include a description of the differences, the risk of misunderstanding is reduced and, accordingly, the description of the applicable financial reporting framework is likely to be adequate.
  
  o If the financial statements do not include a description of the differences, the auditor may conclude, in accordance with ISA 706 (Revised and Redrafted), that it is necessary to draw intended users’ attention to the applicable financial reporting framework, noting that differences between the applicable financial reporting framework and the other established framework may be significant in the context of the entity’s financial statements and, therefore, also to an understanding of the context in which the auditor’s opinion is expressed.
  
  o In extreme cases, the differences may be so significant in the context of the entity’s financial statements that there is an unacceptably high risk that intended users may misunderstand the basis on which the financial statements are prepared. In some cases, this may be so even if the financial statements include a description of the differences. If the auditor concludes, in such circumstances, that the reference to the other established framework in describing the applicable financial reporting framework is misleading, the auditor would express a modified opinion in accordance with ISA 705 (Revised and Redrafted).

B. FINANCIAL STATEMENTS PREPARED IN ACCORDANCE WITH TWO FINANCIAL REPORTING FRAMEWORKS

12. In June the Task Force was asked to reconsider the guidance from International Auditing Practice Statement (IAPS) 1014 in proposed ISA 700 (Redrafted) to ensure that it remains consistent with the IAASB’s final position on the reporting implications of a framework described by reference to another established framework. The Task Force was also asked to consider whether the guidance should be limited to fair presentation frameworks.

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5 IAPS 1014, “Reporting by Auditors on Compliance with International Financial Reporting Standards.”
13. The Task Force concluded that the guidance from IAPS 1014 remains appropriate. The Task Force believes that the situation addressed in paragraph A36 of Agenda Item 5-A is different from the consideration of the adequacy of the description of the applicable financial reporting framework. Paragraph A36 is dealing with disclosures that, whether required by the applicable financial reporting framework or supplementary information provided voluntarily, would be an integral part of the financial statements because it cannot be clearly differentiated from the financial statements due to its nature and how it is presented (paragraph 47). Indeed, it is provided as an example of supplementary information that would be covered by the auditor’s opinion in paragraph A53. Neither fair presentation nor compliance frameworks would permit the financial statements to include disclosures that are misleading, regardless of whether that disclosure is specifically required by the framework or voluntarily provided.

14. The Task Force therefore proposes that paragraph A36 of Agenda Item 5-A, which deals with financial statements that represent compliance with two financial reporting frameworks, be linked to paragraph A53, which deals with supplementary information that cannot be clearly differentiated from the financial statements. In addition, the Task Force proposes to delete the phrase “the financial statements fail to comply with the applicable financial reporting framework” as it may be interpreted to imply that there is an explicit requirement for the disclosure in the framework.

15. As a result, paragraph A36 of Agenda Item 5-A reads as follows:

“As indicated in paragraph A10, the financial statements may represent compliance with the applicable financial reporting framework and, in addition, disclose the extent of compliance with another financial reporting framework. As explained in paragraph A53, such supplementary information is covered by the auditor’s opinion as it cannot be clearly differentiated from the financial statements.

(a) If the financial statements fail to comply with the applicable financial reporting framework because the disclosure as to the compliance with the other framework is misleading, a modified opinion is expressed in accordance with ISA 705 (Revised and Redrafted).

(b) If the disclosure is not misleading, but the auditor judges it to be of such importance that it is fundamental to the users’ understanding of the financial statements, an Emphasis of Matter paragraph is added in accordance with ISA 706 (Revised and Redrafted), drawing attention to the disclosure.”

C. DATE OF THE AUDITOR’S REPORT

16. Paragraph 54 of ISA 700 (Amended) contains the following guidance on the date of the auditor’s report. This text was incorporated in proposed ISA 700 (Redrafted).

“In some jurisdictions, final approval of the financial statements by shareholders is required before the financial statements are issued publicly. In these jurisdictions, final approval by shareholders is not necessary for the auditor to conclude that sufficient appropriate audit evidence has been obtained. The date of approval of the financial statements for purposes of the ISAs is the earlier date on which those with the
recognized authority determine that all the statements that comprise the financial statements have been prepared.”

17. Paragraph A2 of ISA 560 (Redrafted),6 which was published in April 2008, contains similar guidance:

“… In some jurisdictions, final approval of the financial statements by shareholders is required. In these jurisdictions, final approval by shareholders is not necessary for the auditor to conclude that sufficient appropriate audit evidence on which to base the auditor’s opinion on the financial statements has been obtained. The date of approval of the financial statements for purposes of the ISAs is the earlier date on which those with the recognized authority have asserted that all the statements comprising the financial statements have been prepared and that those with the recognized authority have taken responsibility for those financial statements.”

The italicized text does not appear in extant ISA 560 (and, as indicated in paragraph 16 of this paper, in ISA 700 (Amended)).

18. Paragraph A43 of proposed ISA 700 (Redrafted) presented to the IAASB on June 19 showed the following change in marked text.

“… In some jurisdictions, final approval of the financial statements by shareholders is required before the financial statements are issued publicly. In these jurisdictions, final approval by shareholders is not necessary for the auditor to conclude that sufficient appropriate audit evidence has been obtained. The date of approval of the financial statements for purposes of ISAs is the date on which those with the recognized authority conclude that all the statements that comprise the financial statements, including the related notes, have been prepared and that those with the recognized authority have asserted that they have taken responsibility for them.”

The change was processed to align proposed ISA 700 (Redrafted) with paragraph A2 of ISA 560 (Redrafted); however, paragraph A2 of ISA 560 (Redrafted) does not contain the words in italics above. Based on the fact that they appear in the definition of “date of approval of the financial statements” in paragraph 5(b) of ISA 560 (Redrafted) (see paragraph 20 of this paper), the Task Force are now proposing that they be inserted in paragraph A2 of ISA 560 (Redrafted) (see Agenda Item 5-A).

19. The IAASB did not raise any concerns about the abovementioned change on June 19. The Task Force, however, reconsidered it in finalizing Agenda Item 5-A and, as a result, are proposing changes to align the text of paragraph A47 of proposed ISA 700 (Redrafted) and paragraphs 5(b), A2 and A3 of ISA 560 (Redrafted).

20. The Task Force assumed that the words “and that those with the recognized authority have taken responsibility for those financial statements” have been added to paragraph A2 of ISA 560 (Redrafted) to align it with the definition of “date of approval of the financial statements” in paragraph 5(b) of ISA 560 (Redrafted), which reads as follows:

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6 ISA 560 (Redrafted), “Subsequent Events.”
“The date on which all the statements that comprise the financial statements have been prepared and those with the recognized authority have asserted that they have taken responsibility for those financial statements.”

This wording is consistent with the requirement in paragraph 41 of proposed ISA 700 (Redrafted) (see Agenda Item 5-A).

The Task Force, however, is concerned that the words added to paragraph A2 of ISA 560 (Redrafted) (and that, as a result, also appears in paragraph A47 of proposed ISA 700 (Redrafted)) might have changed the original intent of the guidance in extant ISA 700. In the original wording, the guidance explained that, in those jurisdictions where final approval of the financial statements by shareholders is required, the date of approval of the financial statements for purposes of the ISAs is “the earlier date on which those with the recognized authority determine that all the statements that comprise the financial statements, including the related notes, have been prepared.” Thus, final approval of the financial statements by the shareholders is not necessary for the auditor to conclude that sufficient appropriate audit evidence on which to base the auditor’s opinion on the financial statements has been obtained. Also, given that the guidance applies to jurisdictions in which there are complex approval structures, the original focus on the point at which it has been determined that the financial statements are complete may have been for the sake of simplicity, as both conditions are likely to be met simultaneously.

21. The Task Force would appreciate the IAASB’s view on whether the proposed changes to the guidance in ISA 560 (Redrafted) and proposed ISA 700 (Redrafted) should be made or whether the original wording should be reinstated.

D. CONSIDERATION OF THE NEED TO RE-EXPOSE

22. Agenda Item 5-C shows in marked text the changes processed to the exposure draft. The Task Force is of the view that the changes are in response to matters raised by respondents to the exposure draft. They do not introduce new principles or represent other changes of substances when compared with the exposure draft.

23. Accordingly, the Task Force is of the view that re-exposure is not necessary.7

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7 IAASB Working Procedures regarding re-exposure state: “Situations that constitute potential grounds for a decision to re-expose may include, for example: substantial change to a proposal arising from matters not aired in the exposure draft such that commentators have not had an opportunity to make their views known to the IAASB before it reaches a final conclusion; substantial change arising from matters not previously deliberated by the IAASB; or substantial change to the substance of an International Standard or Practice Statement.”
Material Presented
Agenda Item 5-A ISA 700 (Redrafted) – Marked from June 19 IAASB Draft
(Pages 1807 - 1838)
Agenda Item 5-B ISA 700 (Redrafted) – Clean
(Pages 1839 - 1868)
Agenda Item 5-C ISA 700 (Redrafted) – Marked from Exposure Draft
(Pages 1869 - 1906)
Agenda Item 5-D Comments Received from IAASB Members during July/August
(Pages 1907 - 1920)

Action Requested
24. The IAASB is asked to approve as a final standard the proposed ISA 700 (Redrafted).