

IAASB CAG PAPER

IAASB CAG Agenda (March 2008)

Agenda Item C.3.3.1

Clarity – Proposed ISA 700 (Redrafted)

Matters for CAG Consideration—Proposed ISA 700 (Redrafted), “The Independent Auditor’s Report on General Purpose Financial Statements”

1. Forty-nine comment letters were received. Overall, respondents were in agreement with the application of the clarity conventions. Suggestions for improvement focused on relatively few areas.
2. Extant ISA 700¹ had been relatively recently revised (effective for auditor’s reports dated on or after December 31, 2006), following quite a “lively” debate. Whilst the majority of respondents to the exposure draft of proposed ISA 700 (Redrafted) were broadly supportive of the extant ISA, some respondents took the opportunity to raise more fundamental issues with extant ISA 700’s approach to the auditor’s report.

Responses to Requests for Specific Comments

3. The **explanatory memorandum** that accompanied the exposure draft of proposed ISA 700 (Redrafted)² requested respondents to comment on three specific matters.
 - (a) **Transfer of requirements and guidance from proposed ISA 450 (Revised and Redrafted):**³ Virtually all respondents supported the proposal to limit the scope of proposed ISA 450 (Revised and Redrafted) to the evaluation of the effect of uncorrected misstatements, while proposed ISA 700 (Redrafted) dealt with the evaluation whether the financial statements as a whole are free from material misstatement.
 - (b) **Modified IFRS frameworks:** Responses to the proposed guidance, which was developed to address the matter of financial reporting frameworks described by reference to International Financial Reporting Standards (IFRS), were very mixed. They are further analyzed below.
 - (c) **Incorporation of guidance from IAPS 1014:**⁴ Virtually all respondents supported the proposal to incorporate the guidance in IAPS 1014, appropriately amended, in proposed ISA 700 (Redrafted) and to withdraw IAPS 1014.

Financial Reporting Frameworks Described by Reference to IFRS

4. In addition to the clarity redrafting, the IAASB proposed that extant ISA 700 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, IFRS. The proposed amendment introduced guidance on the auditor’s evaluation whether the financial statements adequately refer to or describe the applicable financial reporting framework. The proposal had been developed in conjunction with the International Accounting Standards Board (IASB). The IASB

¹ ISA 700, “The Independent Auditor’s Report on a Complete Set of General Purpose Financial Statements.”

² The explanatory memorandum forms part of the exposure draft of proposed ISA 700 (Redrafted), which can be found at <http://www.ifac.org/Guidance/EXD-Details.php?EDID=0090>.

³ Proposed ISA 450 (Revised and Redrafted), “Evaluation of Misstatements Identified during the Audit.”

⁴ International Auditing Practice Statement (IAPS) 1014, “Reporting by Auditors on Compliance with Financial Reporting Standards.”

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proposed an amendment in their Annual Improvements Exposure Draft to IAS 1,⁵ requiring disclosures in such circumstances.

5. The main element of the proposed amendment to extant ISA 700 was that, if the financial reporting framework was described in the financial statements as being a modified version of an established framework (in particular, modified IFRS), the auditor should consider whether such description may be misleading if the financial statements did not include appropriate details of the difference between the applicable financial reporting framework and the established framework. It followed closely the proposed amendment to IAS 1, though it also sought to generalize the relevant consideration to other frameworks
6. Forty responses were received to the question about the proposed amendment to extant ISA 700. A preliminary staff analysis of the responses indicate that:
 - Twenty-one respondents supported the proposal, although some suggested that it be amended in one way or another. Three respondents, for example, did not agree that the auditor's report should include an Emphasis of Matter(s) paragraph if the financial statements adequately describe the difference between the applicable financial reporting framework and the established framework.
 - Ten respondents did not support the proposal.
 - Some argued that ISAs should be neutral with regard to the financial reporting framework, whereas this guidance was largely directed to IFRSs. A few were concerned about the effect that the guidance may have on the "true and fair" requirement for companies and auditors in the European Union (i.e., if the financial reporting framework is designed to give a true and fair view, but does not require such disclosure, how can the failure to include such disclosure result in financial statements that do not give a true and fair view).
 - Others thought that the proposed additional disclosures would be difficult to enforce in the absence of support in the standards – for example, if the adopting authority did not adopt the proposed amendment to IAS 1, or if the framework was other than IFRS. They argued that it was not the role of auditors to enforce such disclosure when it is not required by the financial reporting framework or regulation.
 - Two respondents were expressly of the view that the matter requires a regulatory rather than an auditing standards solution, though this thought seemed to lie behind other responses as well.
 - A few respondents suggested that the IAASB delay finalization of its proposal until the IASB has finalized its proposal.
7. Other points of interest included the following:

⁵ International Accounting Standard (IAS) 1, "Presentation of Financial Statements."

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- Three respondents suggested that the guidance clarify that the difference between the applicable financial reporting framework and IFRS need not be quantified, while two respondents were of the view that it will be difficult for the auditor to determine whether the financial statements are in fact misleading if the difference is not quantified.
- Two respondents were concerned that the guidance could lead to a proliferation of modified auditors' reports in the European Union.

Objectives

8. The proposed ISA contained the following objectives:

“The objectives of the auditor are to:

(a) Form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and

(b) Express clearly that opinion through a written report that explains the basis of the opinion.”

9. The majority of respondents supported the objectives. Most agreed with the need for two objectives; i.e., one that is focused on forming the opinion, and another that is focused on the auditor's report. Only one respondent was of the view that the objectives could be more outcomes oriented.
10. There were some specific suggestions for improvement. For example, a few respondents suggested ways in which the wording of the objectives could be more closely aligned with that in proposed ISA 200 (Revised and Redrafted,⁶ or with other ISAs (e.g., focusing on the evaluation of audit evidence obtained rather than the conclusions drawn from the audit evidence obtained.

Requirements

11. The majority of respondents were of the view that the criteria identified by the IAASB for determining whether a requirement should be specified have been applied appropriately and consistently, such that the resulting requirements promote consistency in performance and reporting, and the use of professional judgment by auditors.
12. Although some respondents commented on the appropriateness of some of the requirements or suggested refinement, few single requirements received a significant number of comments. Areas which solicited more comment included: forming an opinion (including suggestions on structuring and comments on a possible over-emphasis on management bias in the discussion of the qualitative aspects of the entity's accounting policies), Other Matter(s) paragraphs, and definitions.

⁶ Proposed ISA 200 (Revised and Redrafted), “Overall Objective of the Independent Auditor, and the Conduct of an Audit in Accordance with International Standards on Auditing.”

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Significant Comments that Do Not Relate to the Application of the Clarity Conventions

Scope of the ISA

13. A few respondents referred to their concerns about the scopes of proposed ISA 700 (Redrafted) and proposed ISA 800 (Revised and Redrafted), noted in their responses to the exposure draft of proposed ISA 800 (Revised and Redrafted) – see paragraphs 7-13 of Agenda Item C.3.3.3. In addition, one respondent was of the view that opinions containing the phrases “give a true and fair view” or “present fairly, in all material respects,” should be limited to complete sets of general purpose financial statements prepared in accordance with a fair presentation framework. This respondent was of the view that an auditor’s report on a single general purpose financial statement should not be included in the scope of proposed ISA 700 (Redrafted). It believed that it should fall in the scope of proposed ISA 800 (Revised and Redrafted). Another respondent questioned whether the ability to include a Restriction on Use paragraph in the auditor’s report should be limited to ISA 800 (Revised and Redrafted) if the scope of ISA 700 (Redrafted) includes auditors’ reports on any financial statement prepared and presented in accordance with a general purpose framework.

Consistency in the Auditor’s Report vs. Flexibility

14. One of the most significant issues debated in the revision of ISA 700 was that of the merits of having consistency in the format and wording of an ISA auditor’s report versus allowing greater flexibility. The IAASB was aware that flexibility could facilitate adoption of the revised ISA; however, it would perpetuate differences in auditor’s reports that are difficult to understand in a global marketplace and would have the disadvantage of not making an “ISA audit” (an audit conducted in accordance with globally recognized standards) readily identifiable. At the time, the IAASB opted for consistency. The IAASB believed that having a readily identifiable auditor’s report for audits conducted in accordance with ISAs would promote credibility in the global marketplace. Consistency was also viewed as being useful in promoting users’ understanding and in making unusual circumstances more readily identifiable. A number of respondents to the exposure draft of proposed ISA 700 (Redrafted) resurfaced that debate.

Description of Management’s Responsibility for the Financial Statements

15. Quite a few respondents, in particular – but not limited to – European-based respondents, considered the requirements dealing with the description of management’s responsibility for the financial statements to be too prescriptive **See paragraphs 21-23 of proposed ISA 700 (Redrafted)**. Their concerns included the following:
 - The legal responsibilities of management differ between jurisdictions and different legal forms of entity within jurisdictions. Any attempt to provide an accurate description based on legal requirements would necessarily lead to inconsistencies and incomparability in auditor’s reports.

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- Management is not necessarily required by local law or custom to maintain systems of internal control that are relevant to the preparation and presentation of the financial statements.
 - The auditor's report should not describe management's responsibility for the financial statements if this responsibility is described elsewhere in the financial statements. In some jurisdictions or for certain types of company, for example, it is mandatory for management to issue a separate report, stating its responsibilities.
 - The reference to management may not be appropriate. In some jurisdictions the responsibility for the financial statements falls on those charged with governance or the body of directors as a whole.
16. Some respondents explicitly supported the IAASB's proposal to introduce greater flexibility in how management's responsibilities are described in the exposure draft of proposed ISA 210 (Redrafted)⁷ and related conforming amendments to proposed ISA 200 (Revised and Redrafted) and proposed ISA 700 (Redrafted).
17. The exposure draft of proposed ISA 210 (Redrafted) includes conforming amendments to proposed ISA 700 (Redrafted) that would require that management's responsibilities be described in the auditor's report in the manner that they are described in the terms of the audit engagement. Proposed ISA 210 (Redrafted) introduces greater flexibility in that description. In particular, it proposes to allow the auditor to use the wording of relevant law or regulation to describe management's responsibilities if the auditor has determined that management's responsibilities prescribed by law or regulation are equivalent in effect to those set out in the ISA. For management's responsibilities that are not equivalent in effect, or that are not prescribed by law or regulation, the auditor would be required to use the description in proposed ISA 210.
18. Many viewed this as a welcome solution to an aspect of extant ISA 700 that, in some jurisdictions, has proven to be an impediment to adoption.

Auditor's Report for Audits Conducted in Accordance with Both International Standards on Auditing and Auditing Standards of a Specific Jurisdiction or Country / Auditor's Reports Prescribed by Law or Regulation

19. **Paragraph 40 of proposed ISA 700 (Redrafted)** provides for the auditor's report to refer to ISAs, in addition to national auditing standards, when the auditor has complied with both ISAs and the national auditing standards, if: (a) there is no conflict between the reporting requirements regarding the auditor's report in ISAs and those in the national auditing standards *that affects the auditor's opinion or the need to include an Emphasis of Matter(s) paragraph in the particular circumstances*; and (b) the auditor's report includes, at a minimum, each of the elements in **paragraph 40(b) of proposed ISA 700 (Redrafted)** when the auditor uses the layout

⁷ Proposed ISA 210 (Redrafted), "Agreeing the Terms of Audit Engagements."

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or wording specified by the national auditing standards. There were a number of comments on this requirement – some requesting more flexibility, while others requested less flexibility.

20. A few respondents suggested that **paragraph 40(b)(iv) of proposed ISA 700 (Redrafted)**, which deals with management's responsibility for the financial statements, be deleted. One of those respondents noted that Article 4(1)(c) of the EC Transparency Directive requires listed companies to include statements of management responsibilities within the annual report. It was of the view that repeating them in the auditor's report will cause an unnecessary duplication and risk inconsistency.
21. One respondent was of the view that while, in the context of traditional thinking, a number of the elements in **paragraph 40(b) of proposed ISA 700 (Redrafted)** appear to be self evident, others may limit the opportunity of national standard setters to respond, in an innovative manner, to the calls from user groups to revise the auditor's report to make it more readable and to add to its information value. In particular, this respondent was of the view that, rather than mandating a description of the work that an auditor performs in an audit (**paragraph 40(b)(v) of proposed ISA 700 (Redrafted)**), a more flexible approach could be to require the auditor to (a) evaluate the extent to which the annual report or other publicly available information provides the information that proposed ISA 700 (Redrafted) would otherwise require the auditor to provide in the auditor's report; and (b) refer in the auditor's report to where this information may be found. It encouraged the IAASB to review the elements with a view to limiting them only to those that are absolutely essential. A few other respondents were of a similar view.
22. A few respondents, however, were concerned that the authority of ISAs will be compromised if too much flexibility is allowed in reporting in accordance with ISAs and national auditing standards. They were of the view that **paragraph 40 of proposed ISA 700 (Redrafted)** allowed precedence to national auditing standards (i.e., in those jurisdictions that have not transposed ISAs) over ISAs in respect of layout and wording of the auditor's report, and that this is not conducive to global convergence. They believed that this should only be the case for requirements established by law or regulation.

Other Comments Relevant to Flexibility

23. A few respondents suggested amendments to more clearly articulate what should be included in the Auditor's Report on the Financial Statements section of the report and, thereby, what would be included in the Other Reporting Responsibilities sections. They were concerned that, without further clarification, the requirements could be interpreted differently in different jurisdictions, resulting in a lack of comparability. In their view, the first part of the auditor's report should be limited to the "ISA audit opinion" on whether the financial statements comply with the applicable financial reporting framework. Any other opinions or conclusions, even if related to the financial statements, ought to be included as other reporting responsibilities.
24. One respondent commented on the negative reactions to the structure and length of the auditor's report it had received when it had adopted extant ISA 700 in its jurisdiction. This respondent

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noted that the mandatory structure and wording of the auditor's report limited its ability to respond to these reactions (for example, by moving the opinion earlier in the auditor's report).

25. A few respondents challenged the merits of having a common short auditor's report, and encouraged IAASB to continue to explore with stakeholders whether the traditional audit reporting model continues to meet users' needs.

Matters for Consideration by CAG:

- Q1. What are Representatives' views with regard to responses to the guidance in proposed ISA 700 (Redrafted), which was developed to address the matter of financial reporting frameworks described by reference to, but modified from, IFRS?
- Q2. What are Representatives' views with regard to the comments on **paragraph 40 of proposed ISA 700 (Revised and Redrafted)**?
- Q3. What are Representatives' views with regard to other comments that relate to the debate regarding the relative merits of consistency in reporting?
- Q4. Are there any other comments that Representatives may wish to raise?

Material Presented – IAASB CAG REFERENCE PAPER

Available at

<http://www.ifac.org/Guidance/EXD-Details.php?EDID=0090>

Exposure Draft of Proposed ISA 700 (Redrafted)
(including the explanatory memorandum)