


**INTERNATIONAL FEDERATION
OF ACCOUNTANTS**

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Agenda Item
7

Committee: IAASB
Meeting Location: New York
Meeting Date: July 21-25, 2003

Auditor's Report on Financial Statements
Objectives of Agenda Item

To consider a first draft 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 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 has 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 has also provided input on proposed audit report wording. Input has also been received from the IAASB Consultative Advisory Group and from other stakeholders, including a meeting of European national auditing standard setters.

The Agenda Papers for this meeting include a first draft of the proposed revised ISA 700 and a new ISA 701. As agreed in March, the current ISA 700 will be split into two parts: a revised ISA 700 that will deal with a "clean" auditor's report (i.e., in those circumstances when the auditor is able to express an unqualified opinion and no modification to the audit report is necessary); and a new ISA 701, "Modifications to the Auditor's Report", that will deal with modifications to this standard report wording that are necessary for an emphasis of matter, a qualified opinion, a disclaimer of opinion, or an adverse opinion.

Also included in the Agenda Papers are:

- conforming amendments to ISA 200 and ISA 210 that, together with ISA 700, establish the framework for the auditor's consideration of the entity's financial reporting framework;

- conforming amendments to ISA 560 and ISA 580 to ensure the guidance in the ISAs on the date of the auditor's report is consistent; and
- a minor conforming amendment to ISA 800 to clarify that an audit report on a single financial statement is within the scope of that ISA.

The purpose of the discussion at this meeting is to get the Board's reaction to this first draft. The Task Force's objective is to present Exposure Draft wording for IAASB's approval at the October meeting. An Explanatory Memorandum for the Exposure Draft will be presented at that time.

Activities Since Last IAASB Discussions

Since the May IAASB meeting, the Task Force has had three meetings – a two-day meeting and two conference calls in order to prepare a first draft of Exposure Draft wording of a revised ISA 700 and the various conforming amendments necessary to existing ISAs.

Given the nature and extent of the proposed revisions to ISA 700, a mark-up from the existing text has not been provided. Rather, IAASB members should view the proposed new ISA 700 and new ISA 701 as new ISAs that will replace existing ISA 700. The proposed conforming amendments to other ISAs have, however, been presented as a mark-up from the existing text.

The Task Force has drafted the Exposure Draft wording based on the Board's decisions on the various issues identified in the project proposal at previous meetings. Given the Board's extended discussions on individual issues in previous meetings, the Task Force does not intend to discuss specific issues at the July meeting. Rather the Task Force intends to focus the discussion at the meeting on the proposed wording of ISA 700 and the conforming amendments. However, as reference, a summary of the issues and the positions taken on those issues is provided for information in Agenda Item 7-H.

The following discussion highlights the significant changes since the last meeting.

Financial reporting framework

The major change to the proposals since the May IAASB meeting relates to the auditor's responsibilities with respect to a financial reporting framework chosen by management in the absence of a requirement to adopt IFRSs or other recognized standards.

In response to questions raised by IAASB members in May, the proposed standards do not permit the auditor to accept an engagement for an audit of general purpose financial statements when the financial reporting framework chosen by management is not "comprehensive and authoritative". This position is consistent with the position taken in the Assurance Standards Exposure Draft. Proposed ISAE 2000.16 states:

a practitioner does not accept an assurance engagement unless the practitioner's preliminary knowledge of the engagement circumstances indicates that the criteria to be used are suitable. However, if after accepting the engagement, the practitioner concludes that the criteria are not suitable, the practitioner expresses a reservation or denial of conclusion, or withdraws from the engagement.)

The proposed standards provide criteria for the auditor to use in assessing whether a financial reporting framework is comprehensive and authoritative. It also presumes that standards set by recognized standards setting bodies will by definition be authoritative and comprehensive.

The discussion of the financial reporting framework in the proposed standards is organized as follows:

- Agenda Item 7-A, ISA 200.24 to 33 discuss:
 - what constitutes an applicable financial reporting framework for general purpose financial statements;
 - the factors considered by an auditor in determining whether a financial reporting framework chosen by management is authoritative and comprehensive;
- Agenda Item 7-B, ISA 210.20 to .24:
 - discuss the need for the terms of an audit engagement to identify the applicable financial reporting framework;
 - do not permit an auditor to accept an engagement to audit general purpose financial statements when the financial reporting framework chosen by management is not comprehensive and authoritative; and
- Agenda Item 7-C, ISA 700.43 requires the opinion paragraph of the auditor's report to clearly identify the applicable financial reporting framework.
- ISA 700.10 and .11 also state that:
 - if after accepting an engagement involving a financial reporting framework chosen by management, the auditor identifies deficiencies in the financial reporting framework that were not anticipated when the engagement was accepted, the auditor discusses the reasons for the deficiencies with management and encourages management to address these deficiencies
 - when the auditor concludes the financial reporting framework is not comprehensive and authoritative, the auditor expresses a disclaimer of opinion or withdraws from the engagement

Supplementary financial information

Agenda Item 7-C paragraphs 20-28 set out the Task Force's proposals regarding supplementary information presented together with the financial statements. The proposed wording describes the information that is considered to be covered by the auditor's opinion. This includes the components of a complete set of financial statements, as defined by the applicable financial reporting framework, as well as any voluntary supplementary information that, by its nature or how it is presented, would be considered by a reasonable user to be an integral part of the entity's financial statements. If the entity presents supplementary information together with the financial statements that is not audited, the auditor needs to be satisfied that the unaudited information is clearly differentiated.

The focus of the guidance is on how any supplementary information relates to the auditor's opinion on financial statements. It is not intended to be comprehensive guidance on the auditor's association with supplementary information. For example, it does not address how the auditor might report on supplementary information that is not considered to be covered by the auditor's opinion but on which the auditor has performed procedures. However, the Task Force has drafted the wording so that it does not preclude reporting on those procedures should IAASB decide in future that further guidance on the auditor's association with and reporting on supplementary information is needed. (More extensive guidance is, for example, included in US auditing standards.)

The proposed guidance incorporates suggestions received offline from Board members. For example:

- By way of illustration in paragraph 24, the guidance clarifies that if an entity includes a statement in the notes to the financial statements regarding the extent to which the financial statements comply with another financial reporting framework, it would be considered to be covered by the auditor's opinion because of its nature. This ensures consistency with the principle established in new IAPS 1014.
- Paragraph 28 has been included to remind auditors that, even if the supplementary information is not covered by the audit opinion, the auditor is not relieved of the responsibility to read that information to identify any material inconsistencies with the audited financial statements.

Wording of the auditor's report

The latest version of the Task Force's proposed wording for the auditor's report is set out in paragraph 53 of Agenda Item 7-C and incorporated into the proposed revision of ISA 700. The main changes since the version discussed at the May meeting include:

- Further refinement of the discussion of management's responsibilities.
- Incorporating the "caution" to readers to look to the financial statements to obtain an understanding of the entity's financial position, financial performance and cash flows into the paragraph on management's responsibilities.
- Expanding the wording of the description of the auditor's opinion to refer specifically to obtaining an understanding of the entity and its environment, and to internal control. A new sentence has been added to clarify that the auditor's understanding and procedures do not, however, provide a sufficient basis for expressing an opinion on the design or effective operation of the entity's internal controls. Based on the reaction from CAG and at the May IAASB meeting, other caveats regarding common misconceptions of the audit have been deleted.
- Adding subheadings into the report, which given the length of the report, improve its readability.

Possible implications of the revision to the scope of ISA 800

The proposed revisions to ISA 700 emphasize that the focus of ISA 700 is "general purpose financial statements", i.e., financial statements that are useful to a wide range of users in making economic decisions.

In May, this type of focusing of ISA 700 led a number of IAASB members to question the status of reporting on certain individual financial statements such as a balance sheet. Some IAASB members felt that reporting on such individual statements was within the scope of ISA 700. Others felt that reporting on such statements is covered by ISA 800.

Agenda Item 7-G, proposes a small conforming amendment to ISA 800 to clarify that it addresses reporting an individual financial statement such as a balance sheet. This proposed amendment has led some Task Force members to question whether the guidance in ISA 800 is sufficient to address reporting on such statements. For example, current guidance in ISA 800 does not make it clear that such statements should be accompanied by all related notes. Task Force members also felt that this may become more of an urgent issue with respect to preparation of a balance sheet only as entities in Europe consider first time application of IFRSs.

The Task Force therefore recommends that in addition to the small conforming amendment to ISA 800, IAASB consider whether there is a need to start work on an IAPS that addresses reporting on a balance sheet only with a focus on balance sheets prepared for the purposes of first time application of IFRSs.

Material Presented

Agenda Item 7-A (Pages 905–912)	Proposed revisions to ISA 200, “Objective and General Principles Governing an Audit of Financial Statements”—Mark-up showing combined proposed changes to ISA 200 arising from the Reporting Project and the Audit Risk Exposure Draft.
Agenda Item 7-B (Pages 913–914)	Proposed revisions to ISA 210, “Terms of Audit Engagements”
Agenda Item 7-C (Pages 915–926)	Proposed new ISA 700, “The Independent Auditor’s Report on General Purpose Financial Statements”
Agenda Item 7-D (Pages 927–928)	Proposed new ISA 701, “Modifications to the Auditor’s Report”
Agenda Item 7-E (Pages 929–934)	Proposed revisions to ISA 560, “Subsequent Events”
Agenda Item 7-F (Pages 935–936)	Proposed revisions to ISA 580, “Management representations”
Agenda Item 7-G (Pages 937–938)	Proposed revisions to ISA 800, “The Auditor’s Report on Special Purpose Audit Engagements”
Agenda Item 7-H (Pages 939–948)	Summary of decisions on key issues

Action Requested

IAASB is asked to review the proposed new ISA 700 and ISA 701, together with the proposed conforming amendments to ISAs 200, 210, 560, 580 and 800 and be prepared to provide comments and suggestions for improvement. Any editorial comments should be forwarded to the Task Force.

IAASB is asked to consider whether there is a need to start work on an IAPS that addresses reporting on a balance sheet only with a focus on balance sheets prepared for the purposes of first time application of IFRSs.

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