



**International Federation of Accountants**

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## **Agenda Item**

# **4**

**Committee:** IAASB

**Meeting Location:** New York

**Meeting Date:** February 13-16, 2007

### **ISA 700 (Redrafted), “The Independent Auditor’s Report on General Purpose Financial Statements”**

#### **Objectives of Agenda Item**

1. To conduct a first read of proposed ISA 700 (Redrafted), “The Independent Auditor’s Report on General Purpose Financial Statements.”

#### **ISA 700 Redrafting Task Force Members**

2. The Task Force members are Diana Hillier (Chair) and Sylvia Smith.

#### **Activities of the Task Force**

3. The Task Force used ISA 700 amended as a result of ISA 800 (Revised), “Special Considerations—Audits of Special Purpose Financial Statements and Specific Elements, Accounts or Items of a Financial Statement” (“Amended ISA 700”)<sup>1</sup> as the basis for preparing proposed ISA 700 (Redrafted).
4. Proposed ISA 700 (Redrafted) was reviewed by a small team designated by the Financial Audit Guidelines Subcommittee of INTOSAI. The team concluded that it is not necessary to include public sector audit considerations in the proposed redrafted ISA.

#### **Matters for IAASB Consideration**

MATTERS THAT RELATE TO THE REDRAFTING OF ISAS 700, 705, 706 AND 800

##### *Interrelationship between the Reporting ISAs*

5. One of the questions facing the Task Forces responsible for the various reporting ISAs has been whether the interrelationships among the reporting ISAs are clear to users of the ISAs. A number of alternatives were considered, including creating an introduction to the reporting section to describe the interrelationship, combining some of the ISAs again, and using footnotes to explain each ISAs relationship to the others. After consideration of the alternatives, the Task Forces propose that:

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<sup>1</sup> See Agenda Item 2-E for the close off document of ISA 800 (Revised), which contains Amended ISA 700.

- The introduction to proposed ISA 700 (Redrafted) explain the relationship between ISAs 700 and ISAs 705 and 706;
- Proposed ISAs 705 (Redrafted) and 706 (Redrafted) do not repeat that explanation but refer to the explanation in proposed ISA 700 (Redrafted); and
- No cross references be made in the Introduction sections between proposed ISAs 700 (Redrafted) and 800 (Revised and Redrafted), since the titles of the two ISAs clearly describe their contents.

**Action Requested**

**The IAASB is asked to consider whether the descriptions of the interrelationship between the reporting ISAs in the Introduction sections of the respective ISAs is clear and will enable users of the ISAs to determine which ISA to apply in the particular circumstances of an engagement.**

*Numbering of the Reporting ISAs*

6. The 700- and 705/706-Task Forces also considered the numbering of the proposed redrafted reporting ISAs. The Task Forces are comfortable with proposed ISAs 800 (Revised and Redrafted) and 805 (Redrafted) being in the 800 series, since the scope of these ISAs cover more than reporting issues.
7. Clarity provides an opportunity to rationalize the numbering of the reporting ISAs. As there is no longer a need to have a placeholder for the special reports ISAs (which are now in the 800 series), ISAs 705 and 706 more logically could be numbered ISAs 701 and 702, or preferably ISAs 705 and 710.
8. The Task Forces also considered the ordering of ISAs 705 and 706. Two views emerged:
  - ISA 705 should precede ISA 706 in the series because understanding the circumstances that result in a modified opinion helps distinguish Emphasis of Matters and Other Matter(s) paragraphs, and that order follows their placement in the auditor's report.
  - ISA 706 should precede ISA 705 because it deals with circumstances that would be covered in an unmodified (or "clean) report (this was also the ordering in the original ISA 700).

**Action Requested**

**The IAASB is asked to consider the numbering of the proposed redrafted reporting ISAs.**

*Placement of requirements regarding Other Matters and Other Reporting Responsibilities*

9. At the moment, Other Matter(s) paragraphs are discussed in both ISAs 700 and 706. Amended ISA 700.43 deals with Other Matter(s) and as follows: "Standards, laws or generally accepted practice in a jurisdiction may require or permit the auditor to elaborate on matters that provide further explanation of the auditor's responsibilities in

the audit of the financial statements or of the auditor's report thereon. Such matters may be addressed in a separate paragraph following the auditor's opinion. ISA 706<sup>2</sup> contains standards and guidance for other matter(s) paragraphs in the auditor's report."

10. The Task Forces discussed whether Other Matter(s) should be addressed in only one ISA or in both ISAs and, if in both ISAs, whether the split in the types / examples of other matters in each ISA made sense.
11. The Task Forces concluded that both ISAs should include discussion of Other Matter(s) paragraphs.
  - Certain matters that would be included in Other Matter(s) paragraphs, such as the "basis for conclusions" required in some jurisdictions, are an integral part of every statutory auditor's report. Thus, it is important that those matters be included in ISA 700, which describes the form and content of "clean" auditor's reports.
  - On the other hand, other matters that would be included in such paragraphs are a response to special circumstances – for example the requirement to explain a material inconsistency in other information containing audited financial statements. The discussion of such matters would be out of place in ISA 700, but better placed in ISA 706.
12. The Task Forces, however, have tried to clarify better how the Other Matter(s) referred to in ISA 700 relate to those in ISA 706.
13. The Task Forces also discussed whether certain requirements related to the placement and identification of such paragraphs (i.e., the "Other Matters" subheading) should be

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Paragraph 17 of the close off document of ISA 706 reads as follows: Examples of other matters that are not required to be recognized or disclosed in the financial statements by the applicable financial reporting framework include the following:

- (a) Avoidance of auditor association with materially inconsistent information in a document containing audited financial statements (see ISA 720, "Other Information in Documents Containing Audited Financial Statements").
- (b) Circumstances where the incoming auditor is permitted to refer to the predecessor auditor's report on the corresponding figures in the incoming auditor's report for the current period (see ISA 710, "Comparatives").
- (c) Where standards or laws require, or generally accepted practice in a jurisdiction permits, the auditor to elaborate on matters that provide further explanation of the auditor's responsibilities in an audit of financial statements or of the auditor's report thereon.
- (d) In rare circumstances, other matters that the auditor considers necessary to communicate to the user, for example, where the auditor judges it necessary to explain why the auditor is unable to resign from the engagement even though the possible effect of an inability to obtain sufficient appropriate audit evidence due to a scope limitation imposed by management is pervasive.

transferred from ISA 706 to ISA 700. However, no changes were made for the following reasons:

- ISA 700 does not mandate the use of subheadings in an auditor's report that does not have a modified opinion or an Emphasis of Matter or Other Matter(s) paragraph. The issue was debated when ISA 700 was revised and the IAASB decided not to mandate subheadings as there was not consensus among respondents or IAASB members on the issue. When ISA 706 was developed, the IAASB debated whether to make a conforming amendment to ISA 700 to mandate the use of subheadings in all auditors' reports (which are required when the auditor's opinion is modified), but concluded that subheadings, whilst important in reports with modified opinions, are not necessary in "clean" auditors' reports.
- Transferring the requirement in ISA 706 to include a subheading for Other Matter(s) paragraphs to ISA 700 would be inconsistent with the approach in ISA 700, unless the IAASB changes its view on subheadings in "clean" auditors' reports.
- Similarly, although ISA 700 specifies that Other Matter(s) and Other Reporting Responsibilities should follow the auditor's opinion on the financial statements, it does not specify the order. Thus, transferring requirements on the placement of them vis-à-vis Emphasis of Matter paragraphs, for example, would be inconsistent. Furthermore, whilst some matters that can be included in Other Matter(s) would logically fit after the auditor's opinion on the financial statements (e.g., reference to a predecessor auditor), others might better fit at the end of the auditor's report (e.g., "Bannerman"-type wording that would be applicable to not only the auditor's opinion on the financial statements but to the other reporting responsibilities as well.)

#### **Action Requested**

**The IAASB is asked to consider the split of the requirements and guidance regarding the content, placement and identification of Other Matter(s) paragraphs.**

#### *Effective Date*

14. The Task Force proposes that the redrafted reporting ISAs indicate that they are effective for auditors' reports dated on or after December 15, 2009.<sup>3</sup> This aligns their effective dates with those of the recently redrafted performance ISAs, which are effective for audits of financial statements for periods beginning on or after December 15, 2008. Setting the date as December 15, 2009 will capture reporting entities with financial reporting years that start on December 16, 2008. However, it will not capture reporting entities with financial reporting periods shorter than one year.

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<sup>3</sup> A footnote indicates that the effective date is provisional, but that it will not be earlier than December 15, 2009.

**Action Requested**

**Does the IAASB agree with the proposed effective date for the redrafted reporting ISAs.**

MATTERS THAT RELATE TO THE REDRAFTING OF ISA 700 ONLY

*Terminology – “Auditor Shall” vs. “Auditor’s Report Shall”*

15. Most of the requirements in the redrafted / proposed redrafted ISAs are framed in the context of “the auditor shall.” Amended ISA 700, however, refers to “the auditor’s report should.” In the first redraft of Amended ISA 700, the Task Force attempted to rephrase the requirements so that they were placed as an obligation on the auditor, i.e., “the auditor shall,” but the Task Force concluded that this construction would cause confusion in a number of cases. The two examples below illustrate the problems that arise.

- Amended ISA 700.24 requires the following: “The auditor’s report should state that management is responsible for preparing and presenting the financial statements ...” Changing this to “the auditor shall state that management is responsible for preparing and presenting the financial statements ...” may be interpreted as the auditor defining management’s responsibility (incorrect interpretation) rather than the auditor’s report explaining the premises regarding management’s responsibilities that underlie the audit (correct interpretation). An alternative construct would be: “the auditor shall state in the auditor’s report that management is responsible for preparing and presenting the financial statements ...,” but this seems cumbersome, particularly in light of the number of requirements.
- Amended ISA 700.48 requires that “the auditor’s report should be signed.” Changing this to “the auditor shall sign the auditor’s report” may be interpreted as requiring the auditor to sign the auditor’s report in his or her own name. It may also be interpreted as requiring the auditor to manually sign the auditor’s report, whereas the wording in extant ISA 700 was consciously designed to allow for either manual or electronic signatures.

The recently approved redrafted ISAs, in a limited number of cases, contain references other than “the auditor shall.” These include redrafted ISA 240.44 and 45, which refer to “the auditor’s documentation ... shall;” redrafted ISA 315.6, which refers to “the risk assessment procedures shall;” and redrafted ISA 330.21, which refers to “the auditor’s substantive procedures shall.”

16. The Task Force proposes that, where applicable, the requirements in proposed ISA 700 (Redrafted) be framed in the context of “the auditor’s report shall.”

**Action Requested**

**The IAASB is asked for its views in this regard.**

*Forming an Opinion on the Financial Statements – Requirements vs. Application Material*

17. The Task Force debated whether to move paragraphs 8(a)-(b), 9(a)-(f) and 11(a)-(b) of proposed ISA 700 (Redrafted) to the application material. The Task Force concluded that the requirements in paragraphs 8, 9 and 11 are less understandable without the subparagraphs. The Task Force agreed to retain them as requirements, but to seek the IAASB's advice in this regard.

**Action Requested**

**The IAASB is asked for its view on the split between requirements and application material, if any, of the text in paragraphs 8, 9 and 11 of proposed ISA 700 (Redrafted).**

*Misleading Test in Case of Compliance Frameworks*

18. Paragraph A3 of proposed ISA 700 (Redrafted) explains that it will be extremely rare for the auditor to consider financial statements that are prepared and presented in accordance with compliance framework (which the auditor has determined to be acceptable) to be misleading. Paragraph 14 of proposed ISA 700 (Redrafted) deals with the auditor's actions in the extremely rare circumstances when, in the auditor's professional judgment, such financial statements are misleading.
19. The ISAs, however, do not include a requirement for the auditor to evaluate whether financial statements prepared and presented in accordance with a compliance framework are not misleading; while paragraph 11 of proposed ISA 700 (Redrafted) requires the auditor, when forming an opinion on financial statements prepared and presented in accordance with a fair presentation framework, to evaluate and conclude whether those financial statements achieve fair presentation. The Task Force questioned whether there should a parallel requirement for compliance frameworks, particularly in view of the proposed changes to ISA 550 (Revised and Redrafted).
20. According to proposed ISA 550 (Revised and Redrafted), for example, one of the auditor's objectives is to obtain an understanding of the entity's related party relationships and transactions sufficient to be able to form the auditor's opinion, in accordance with ISA 700, on whether the financial statements achieve fair presentation (for fair presentation frameworks) or are not misleading (for compliance frameworks), even if the applicable financial reporting framework establishes minimal or no related party requirements. To provide a hook for the related requirement in proposed ISA 550 (Revised and Redrafted) and other similar requirements in the ISAs, the Task Force proposes that the IAASB consider whether to include in proposed ISA 700 (Redrafted) a requirement for the auditor, when forming an opinion on financial statements prepared and presented in accordance with a compliance framework, to be satisfied that the financial statements are not misleading in the circumstances.

**Action Requested**

**The IAASB is asked to consider this matter. Is the reference to actions the auditor takes when, in the auditor's professional judgement, the financial statements are misleading, as**

**described in paragraph 14 of proposed ISA 700 (Redrafted), together with the auditor's overriding ethical responsibilities enough?**

*Other Reporting Responsibilities*

21. Paragraphs 29 and A22-A24 of proposed ISA 700 (Redrafted) deal with Other Reporting Responsibilities. These paragraphs explain that, in some jurisdictions, the auditor may have additional responsibilities to report on other matters that are supplementary to the auditor's responsibility to express an opinion on the financial statements. In accordance with paragraph 29 of proposed ISA 700 (Redrafted), when the auditor addresses other reporting responsibilities within the auditor's report on the financial statements, such responsibilities are addressed in a separate section in the auditor's report that follows the auditor's opinion.
22. In some jurisdictions, the auditor is required to express additional opinions in relation to the financial statements. For example, in a number of jurisdictions, the auditor is required to give separate opinions on whether the financial statements comply with the requirements of the applicable financial reporting framework and whether they give a true and fair view or present fairly, in all material respects. Auditors are also frequently asked to express an opinion whether the financial statements comply with specific requirements of law or regulation. Some of those requirements may relate to matters that extend beyond disclosures necessary to give a true and fair view of or present fairly, in all material respects, the financial statements.
23. For example, the German Commercial Code (Code) requires corporations carrying on a commercial business to apply a financial reporting framework contained in the Code with the following characteristics:
  - (a) The financial statements must provide a true and fair view of the financial position, financial performance (and in some cases, cash flows) of the corporation in accordance with the requirements of the Code.
  - (b) The financial statements must also comply with every individual requirement (in particular, individual disclosure requirements) of the Code even though some of the disclosure requirements have corporate governance or other objectives that do not relate to the true and fair view of the financial position or performance of the corporation.
  - (c) The financial statements must comply with any accounting requirements (e.g., on the exercise of alternative treatments permitted by the Code) set forth in the articles of incorporation of the corporation.

The Code requires that the audit, and hence the auditor's opinion, extend to each of these assertions (i.e., there are three opinions on the financial statements) in the same auditor's report.

24. The IDW has noted to the Task Force (and the Modifications Task Force) that it is unclear where, and how, the additional opinions on the financial statements beyond the true and fair view ought to be addressed in an auditor's report issued in accordance with

the ISAs. Different interpretations are possible when reading the wording of Amended ISA 700.

- **Interpretation 1:** The additional opinions do not fall under other reporting responsibilities as described in Amended ISA 700, because all three of the required opinions relate to the financial statements. Amended ISA 700.44 and 47 refer to other reporting responsibilities as being “additional responsibilities to report on other matters that are supplementary to the auditor’s responsibility to express an opinion on the financial statements” and “other reporting responsibilities in a separate section of the report in order to clearly distinguish them from the auditor’s responsibilities for, an opinion on, the financial statements.” Furthermore, the German reporting requirements do not meet the descriptions of the types of matter that can be included in Other Matter(s) paragraphs or Emphasis of Matter(s) paragraphs in accordance with ISA 706.
- **Interpretation 2:** The additional opinions cannot be included in the opinion paragraph of the auditor’s report. Both ISAs 200 and 700 are written from the perspective that the auditor forms “an” opinion on the financial statements and states that the appropriate opinion depends on whether it is a fair presentation framework (true and fair view / presents fairly, in all material respects) or a compliance framework (prepared in accordance with). Amended ISA 700.42,<sup>4</sup> read with paragraphs 19 and 20 of ISA 210 (amended as a result of ISA 800 (Revised)),<sup>5</sup> seem

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<sup>4</sup> Amended ISA 700.42 reads as follows: “When the applicable financial reporting framework encompasses financial reporting standards supplemented by legal or regulatory requirements, the auditor identifies the applicable financial reporting framework in such terms as: ‘... in accordance with International Financial Reporting Standards and the requirements of Country X Corporations Act.’ (ISA 210, ‘Terms of Audit Engagements’ contains standards and guidance for circumstances where there are conflicts between the financial reporting standards and the legislative or regulatory requirements.)”

<sup>5</sup> Paragraph 19 of ISA 210 (amended as a result of ISA 800 (Revised)) reads as follows: “In some jurisdictions, legislative or regulatory requirements may supplement the financial reporting standards established by an authorized or recognized standards setting organization with additional requirements relating to preparing and presenting financial statements. This may, for example, be the case when legislative or regulatory requirements prescribe disclosures in addition to those required by the financial reporting standards or when they narrow the range of acceptable choices that can be made within the financial reporting standards.”

Paragraph 20 reads as follows: “Where financial reporting standards established by an authorized or recognized standards setting organization are supplemented by legislative or regulatory requirements, the auditor determines whether there are any conflicts between the financial reporting standards and the additional requirements. Where such conflicts exist, the auditor discusses the nature of the additional requirements with management and whether (a) the additional requirements can be met through additional disclosures in the financial statements, or (b) the description of the applicable financial reporting framework in the financial statements can be amended accordingly. If this is not possible, the auditor considers whether it is necessary to modify the opinion in the auditor’s report in accordance with ISA 705, ‘Modifications to the Opinion in the Independent Auditor’s Report.’”



to presume that laws and regulations (e.g., the “requirements of Country X Corporations Act”) will always have an affect on the opinion in relation to the true and fair view assertion (and, therefore, form an integral part of “the” applicable financial reporting framework). Even though Amended ISA 700 would permit compliance opinions instead of fair presentation opinions for general purpose financial statements, it does not contemplate both at the same time. Furthermore, by including opinions beyond the true and fair view opinion in the auditor’s opinion paragraph, the IAASB would be defeating one of the primary objectives of the ISA 700 revision, which was to have consistency in an ISA auditor’s report for the opinion on the financial statements.

25. IDW suggested the following possible solutions:
- (a) Clarify that compliance opinions and true and fair view opinions may exist concurrently and that they should both be included in the first part of the auditor’s report, even if these opinions are at variance with one another.
  - (b) Amending the scope of the Other Reporting Responsibilities section of Amended ISA 700 to include additional opinions on the financial statements beyond the base ISA true and fair view or compliance opinion (as is the required opinion based on the framework).
26. Germany will not be the only country grappling with this issue. The United Kingdom’s new Company Law, in future, will require three opinions (true and fair view, properly prepared in accordance with IFRSs, and in compliance with the Company Law).
27. The Task Force agrees that Amended ISA 700 is not entirely clear in relation to whether there can be multiple opinions on the financial statements in part 1 of the auditor’s report, and whether there can be opinions related to the financial statements in part 2 of the auditor’s report. Clarification is needed to enable auditors and jurisdictions to interpret ISA 700 consistently. The Task Force can see valid arguments in support of both alternatives.
28. Including only one opinion in part 1 of the auditor’s report (e.g., a true and fair view opinion in the case of a fair presentation framework) achieves the objective of ensuring consistency across auditor’s reports in part 1 and would enable a clear “line” to be drawn in determining what belongs in part 1 vs. part 2. It also keeps the description of management’s responsibilities simple.
29. On the other hand, if both opinions relate to exactly the same subject matter (i.e., the financial statements), readers may find it easier to understand the auditor’s report if both opinions are presented together.
30. A complication if more than one opinion is included in part 1 of the auditor’s report is that it may not be clear how to reflect this in the description of management’s responsibilities. If there are, in reality, two different reporting frameworks, the description of management’s responsibilities would have to be amended to refer to the fact that the financial statements are prepared in accordance with two frameworks. However, the extent of detail that would have to be disclosed is unclear. For example, it is unclear whether the description would have to distinguish between circumstances

when law or regulation form part of the framework supporting the true and fair view opinion (as contemplated in ISA 200 (amended as a result of ISA 800 (Revised)), and those when two separate, independent opinions (true and fair view and compliance) are required.

31. The Task Force believes that clarity on this matter is important to the consistent interpretation and implementation of ISA 700, but that it extends beyond the redrafting exercise. The Task Force therefore seeks the IAASB's views on the preferred option and proposes that this be identified as an issue in the explanatory memorandum of the exposure draft of proposed ISA 700 (Redrafted), seeking comment on it to ensure due process of any clarifying language.

**Action Requested**

**The IAASB is asked to consider the matter discussed in the preceding paragraphs.**

**Material Presented**

Agenda Item 4-A            Proposed ISA 700 (Redrafted)  
(Pages 295 – 316)

Agenda Item 4-B            Proposed ISA 700 (Redrafted): Mapping Documents  
(Pages 317 – 372)

**Action Requested**

32. The IAASB is asked to consider the matters highlighted above and to review proposed ISA 700 (Redrafted).