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Committee: IAASB Consultative Advisory Group

Meeting Location: Paris

Meeting Date: May 11-12, 2006

Special Reports—Significant Comments on Proposed ISA 701, “The Independent Auditor’s Report on Other Historical Financial Information”

Objectives of Agenda Item

1. To receive a report on the significant comments received on the Exposure Draft of Proposed ISA 701, “The Independent Auditor’s Report on Other Historical Financial Information” (ED-ISA 701), the Task Force’s recommendations and the IAASB’s responses.
2. ED-ISA 701 deals with the independent auditor’s report issued as a result of an audit of historical financial information other than a complete set of general purpose financial statements prepared in accordance with a financial reporting framework designed to achieve fair presentation.

Overall Comments

3. A small majority of respondents expressed general support for the requirements and guidance in ED-ISA 701 – some, however, with reservation. Other respondents had varying degrees of concerns about various matters dealt with in ED-ISA 701. Their most serious concerns related to the significant issues discussed with the IAASB in March 2006, i.e.:

Issue 1: Whether ISA 200, “Objective and General Principles Governing an Audit of Financial Statements” and ISA 210, “Terms of Audit Engagements” apply to all financial statements or to general purpose financial statements only.

Issue 2: The description of the financial reporting framework, and the proposed list of factors that the auditor may consider when evaluating the acceptability of the framework.

Issue 3: When it is appropriate to use the phrase “true and fair/fairly presents” in audit opinions.

Issue 4: Whether the right split has been made between the scope of ISA 700 (Revised), “The Independent Auditor’s Report on a Complete Set of General Purpose Financial Statements” and that of ED-ISA 701.

Issue 5: Whether, and how, the ISAs should address audits of specific elements, accounts or items of a financial statement.

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4. Some of these issues are closely related to the financial reporting framework applied in preparing the financial statements. The Task Force was cautious not to develop proposals that will lead to the IAASB taking on the role of an accounting standard setter.

Significant Issues for Consideration by the IAASB CAG

WHAT IS AN ACCEPTABLE FINANCIAL REPORTING FRAMEWORK

Description of the Financial Reporting Framework

5. ED-ISA 701.10 recognizes that the auditor may be engaged to report on the audit of a wide variety of historical financial information. Such financial information may be designed to meet the common financial information needs of a wide range of users or the financial information needs of specific users. It may be prepared in accordance with financial reporting standards established by authorized or recognized standards setting organizations or the financial reporting provisions of regulators. The financial reporting standards established by an authorized or recognized standards setting organization may be supplemented with legislative or regulatory requirements. Some financial reporting standards adopted by management may not be established by authorized or recognized standards setting organizations or by regulators. This may be because such organizations do not exist or they may not have established financial reporting standards for financial statements prepared by certain specified entities or to meet specific objectives (e.g., to meet the financial information needs of specific users).
6. Furthermore, most financial reporting frameworks adopted by management do not derive their accounting principles or the application of these principles from financial reporting standards and legal or regulatory requirements alone. Such frameworks are often influenced by published views of varying authority, industry practice and accounting literature that address the interpretation and application of specific requirements. The description of financial reporting framework in ED-ISA 701.10 gives recognition to these other sources, leading the auditor to consider the entire framework when determining the acceptability of the framework and how its requirements are applied in practice.
7. Although there was general agreement with the proposal in ED-ISA 701.101 to extend the

¹ ED-ISA 701.10 reads as follows: Financial reporting frameworks presumed to be acceptable for general purpose financial statements are described in ISA 200. ISA 200, paragraph 45, acknowledges that, in some jurisdictions, legislative and regulatory requirements may supplement a financial reporting framework with additional requirements relating to preparing and presenting the financial statements. In these jurisdictions, the applicable financial reporting framework, for the purposes of applying the ISAs, encompasses both the identified financial reporting framework and such additional requirements, provided they do not conflict with the applicable financial reporting framework. For purposes of this ISA, the financial reporting framework may also encompass:

- The effect of the legal and ethical environment, including statutes, regulations, court decisions, and professional ethical obligations in relation to accounting matters;
- Published views of varying authority on emerging accounting issues and accounting interpretations issued by standards setting, professional or regulatory organizations;
- Industry practices widely recognized and prevalent;

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sources that may be encompassed within a financial reporting framework for special purpose financial statements, there was disagreement about whether all sources proposed were appropriate, concern about the authority of the various sources and how conflicts amongst them, and between them and established financial reporting standards, might be resolved, and concern about whether the proposal applies to general purpose financial statements as well as special purpose financial statements.

8. The Task Force recommended that the description of financial reporting framework in the ED- ISA 701, appropriately amended, be retained and moved to ISA 200. It also recommended that new guidance in ISA 200 clarify that the auditor considers the relative authority of the different sources from which the financial reporting principles are derived, and, where conflicts exist amongst them, that the source with the highest authority prevails.
9. The IAASB supported the Task Force's recommendation, but asked that the Task Force in describing the financial reporting framework distinguish between (a) financial reporting standards established by authorized or recognized standards setting organizations and legislative and regulatory requirements (or, in the case of special purpose financial statements, the financial reporting provisions of a regulator or a contract); and (b) the different sources from which management has obtained guidance for applying the financial reporting standards and legislative and regulatory requirements (or the financial reporting provisions of a regulator or a contract).
10. **Paragraphs 36b-d of ISA 200 (Agenda Item J.1)**, reflect implementation of the above decisions. One effect of this is that the guidance applies equally to general purpose as well as to special purpose financial statements. The Task Force considers this to be appropriate, and is of the view that it does not weaken the requirements and guidance relating to general purpose financial reporting frameworks that were developed as part of the revision of ISA 700 and discussed by the IAASB CAG at the time of approving ISA 700 (Revised).

Factors that the Auditor may Consider when Determining the Acceptability of the Financial Reporting Framework

11. Some respondents were concerned about the factors that the auditor considers when determining the acceptability of the financial reporting framework (ED-ISA 701.11²).

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- Accounting literature; and
 - The provisions of a contract, including significant interpretations made by the responsible party in preparing and presenting the financial information. (An interpretation is significant if another reasonable interpretation would have produced a material difference in the other historical financial information.)

² ED-ISA 701.11 reads as follows: Unless the financial reporting framework is an established financial reporting framework recognized as suitable for the intended use, or specifically required to be used by law or regulation, the auditor considers whether it exhibits the characteristics of suitable criteria described in the Framework, paragraph 36. The relative importance of each of these characteristics to a particular engagement is a matter of professional judgment, and depends on the nature of the entity and its environment, the nature and objective of the other historical financial information, the information needs of the intended users, and other matters, for

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They were of the view that some of the factors may undermine frameworks applied in preparing general purpose financial statements.

12. ISA 200.38 states that the auditor determines whether the framework adopted by management is acceptable in view of the nature of the entity and the objective of the financial statements. The Task Force reconsidered the factors in ED-ISA 701.11 and is of the view that the auditor's determination of the acceptability of the framework may also be affected by other factors such as the nature of the financial statements and any applicable legislative and regulatory requirements. The Task Force believes that additional examples of factors will assist the auditor in determining the acceptability of frameworks applied in preparing both general purpose and special purpose financial statements (rather than permitting the auditor to accept unacceptable frameworks as believed by some respondents). **Paragraph 38 of ISA 200 (Agenda Item J.1)**, reflect implementation of this recommendation.

Matters for Consideration by the IAASB CAG:

1. Do the Representatives agree with the proposed description of the financial reporting framework?
2. Do the Representatives agree with the examples of factors that may affect the auditor's consideration of the acceptability of the applicable financial reporting framework?

WHAT FORM OF OPINION SHOULD BE EXPRESSED IN WHICH CIRCUMSTANCES

13. ED-ISA 701.15-16 proposed the following forms of opinion:
 - (a) The auditor uses the terms “give a true and fair view” or “are presented fairly, in all material respects,” to express the audit opinion on other historical financial information prepared in accordance with a financial reporting framework designed to achieve fair presentation of the specific information presented.
 - (b) In the case of other historical financial information prepared in accordance with a financial reporting framework not designed to achieve fair presentation of the specific information presented, the auditor expresses an opinion on the appropriateness of the preparation and presentation of the other historical financial information in accordance with the applicable financial reporting framework. The auditor uses the term “properly prepared, in all material respects, in accordance with the applicable financial reporting framework” to express the audit opinion. The financial reporting framework may be designed for a general or special purpose.

example, events, transactions, conditions and practices that may have a significant effect on the engagement. For example, for the purposes of a balance sheet prepared to establish the value of net assets of an entity at the date of its sale, the vendor and the purchaser may have agreed that very prudent estimates of allowances for uncollectible accounts receivable are to be made. This may result in preparing financial information that is not neutral (see paragraph 36(d) of the Framework), but it may nevertheless be acceptable in the circumstances.

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14. Many respondents stated that they were in agreement with ED-ISA 701.15-16. Some respondents, however, were concerned about the use of the phrase “true and fair/fairly presents” in opinions on historical financial information other than complete sets of general purpose financial statements. Some suggested that it be limited to complete sets of financial statements and single financial statements. Others suggested that it be limited to complete sets of financial statements (and possibly also to balance sheets). Respondents also commented on the phrase “financial reporting framework designed to achieve fair presentation of *the specific information presented*,” and the fact that they were not able to identify a recognized financial reporting framework that explicitly deals with the preparation of financial information other than a complete set of financial statements.
15. Comments indicate that not all respondents attribute the same meaning to the phrase “true and fair/fairly presents” and do not have a similar understanding of the circumstances in which such an opinion should be permitted.
16. The Task Force is of the view that, subject to applicable law or regulation, the form of opinion is determined by the applicable financial reporting framework, and that fair presentation is achieved when the applicable financial framework:
 - (a) Provides a context for the auditor’s evaluation of the fair presentation of the financial statements; and
 - (b) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond the specific requirements of the framework; or
 - (c) Acknowledges explicitly that, in extremely rare circumstances, it may be necessary for management to depart from the specific requirements of the framework to achieve fair presentation of the financial statements.

Although the framework may not specify how to account for or disclose all transactions or events, it ordinarily embodies sufficient broad principles that can serve as a basis for developing and applying accounting policies that are consistent with the concepts underlying the requirements of the framework. Thus, the framework provides a context for the auditor’s evaluation of the fair presentation of the financial statements, including whether the financial statements have been prepared and presented in accordance with the specific requirements of the framework for particular classes of transactions, account balances and disclosures.

Form of Opinion on Complete Sets of Financial Statements

17. The IAASB accepted the Task Force’s recommendation that, for complete sets of financial statements, the form of opinion be linked exclusively to whether the framework is a fair presentation framework. Thus, in the case of a fair presentation framework, the opinion would be either that “the financial statements give a true and fair view of or present fairly, in all material respects, the financial position, financial performance and cash flows of the entity in accordance with the framework;” or “the financial statements are fairly presented,

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in all material respects, in accordance with the framework.” In all other cases, the required opinion would be that the financial statements are prepared, in all material respects, in accordance with the framework.

Form of Opinion on Single Financial Statements

18. As regards the form of opinion on single financial statements (e.g., a balance sheet), the Task Force identified two alternative approaches. In the first approach, the form of opinion is determined in the exact same way as it is determined for a complete set of financial statements. Thus, the approach in paragraph 17 would be followed. There may, however, be financial reporting frameworks that, while they are fair presentation frameworks, explicitly reject the idea that fair presentation can be achieved by anything other than a complete set of financial statements. In such cases, for the purpose of reporting on a single financial statement, the framework cannot be regarded as a fair presentation framework, and the required opinion would be a compliance audit opinion. In cases where a fair presentation framework is silent as to whether fair presentation can be achieved by a single financial statement, it is presumed that a fair presentation opinion would be acceptable.
19. The second approach is to require “prepared, in all material respects in accordance with” opinions for all single financial statements. This approach would be to require compliance audit opinions for all single financial statements. The presumption would be that a financial reporting framework, even if a fair presentation one, does not lead to fair presentation of anything other than a complete set of financial statements. This presumption could be rebutted by the provisions of applicable law or regulation, or explicit confirmation in the applicable financial reporting framework that a single financial statement is capable of achieving fair presentation (of, for example in the case of a balance sheet, the financial position). A very small majority of IAASB members preferred this approach.
20. The Task Force reconsidered the alternative approaches to the form of opinion on single financial statements. It noted that a number of jurisdictions, through law or regulation or custom or practice, did permit fair presentation opinions on single statements; in some cases the financial reporting framework was silent on the issue. Further, the responses to ED-ISA 701 indicated that few, if any, frameworks explicitly expressed views on the issue. The Task Force concluded that the direction from the IAASB at the March 2006 meeting was not sufficiently conclusive to force an approach that may require significant changes in practice in some jurisdictions. Furthermore, the Task Force is of the view that this issue has mainly arisen as a result of theoretical debates about International Financial Reporting Standards, and its application in the context of first-time application or various regulatory filings, and that a definitive solution, therefore, lies with the International Accounting Standards Board, other authorized or recognized standards setting organizations or regulators. The Task Force is not aware of the matter being raised as an issue under other frameworks. **Paragraphs 51b-c of ISA 200 (Agenda Item J.1)**, therefore reflects the approach described in paragraphs 17 and 18.

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Matters for Consideration by the IAASB CAG:

3. The Representatives are asked for their views on the Task Force’s proposals with regard to the form of opinion on single financial statements.

4. The Representatives are also asked to consider whether users of financial statements attach any significance to the different forms of opinion – that is:

- “the financial statements give a true and fair view of or present fairly, in all material respects, the financial position, financial performance and cash flows of the entity in accordance with the framework” or “the financial statements are fairly presented, in all material respects, in accordance with the framework;” and
- “prepared, in all material respects, in accordance with the framework.”

SHOULD THE ISAS ADDRESS AUDITS OF SPECIFIC ELEMENTS, ACCOUNTS OR ITEMS OF A FINANCIAL STATEMENT

21. The current ISA, which proposed ISA 701 is intended to replace, includes requirements and guidance on reporting on specific elements, accounts or items of a financial statement (e.g., separate reporting on, say, accounts receivable). It implies, through example reports, that fair presentation opinions may be given on such information. It gives virtually no guidance on how ISAs as a body are to be applied to such limited audits.
22. A majority of respondents agreed that the ISAs should address audits of specific elements, accounts or items of a financial statement. A small number of respondents, however, were of the view that the ISAs should not contain any such requirements and guidance. Further, a small number of respondents disagreed with, or questioned the completeness of, the proposed requirements and guidance. In particular, respondents were concerned about leaving it to the auditor’s judgment to determine which ISAs, or requirements thereof, are relevant to the audit of a specific element, account or item of a financial statement (see ED-ISA 701.7³). Many respondents were concerned about using the phrase “true and fair/fairly presents” in the auditor’s opinion on a specific element, account or item of a financial statement.

³ ED-ISA 701.7 reads as follows: ISA 200, paragraph 4, requires the auditor to comply with relevant ethical requirements relating to an audit engagement. ISA 200, paragraph 11, requires the auditor, in determining the audit procedures to be performed in conducting an audit in accordance with ISAs, to comply with each of the ISAs relevant to that audit. These requirements apply to an audit of a specific element, account or item of a financial statement. If an audit of a specific element, account or item of a financial statement is conducted in conjunction with the audit of the financial statements of which it forms a part, this is unlikely to cause difficulty. If such an audit, however, is carried out separately, compliance with each of the ISAs relevant to the audit requires careful consideration and may not be practicable. Where an audit in accordance with ISAs is not practicable, the auditor discusses with the responsible party whether another type of engagement may be more practicable.

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23. The Task Force is of the view that the responses to ED-ISA 701 indicate that there is a need for requirements and guidance on audits of specific elements, accounts or items of a financial statement because there are well established practices relating to reporting on such items in a number of jurisdictions. The requirements and guidance should not be limited to reporting considerations, but should also include planning and performance considerations. The completion of proposed ISA 701, however, should not be delayed until such requirements and guidance have been developed.
24. The Task Force therefore recommended that (a) the IAASB initiate a separate project to develop a separate ISA on the special considerations in the audit of specific elements, accounts or items of a financial statement; (b) in the interim, ED-ISA 701.7, appropriately amended to take account of the comments to the extent possible in the circumstances, be moved to ISA 200; and (c) the reporting requirements and guidance, including examples, within extant ISA 800 be retained in ISA 701 until the project in (a) commences. The IAASB agreed that (b) and (c) should be adopted. Considering the public interest aspects of IAASB projects, however, it is unlikely that the project recommended in (a) will be of high priority to the IAASB.

Matters for Consideration by the IAASB CAG:

5. The Representatives are asked for their views on the IAASB's decision with regard to audits of specific elements, accounts or items of a financial statement.

25. Based on a comment raised by the CAG Working Group, the Task Force also considered the completeness of the scopes of ISA 700 (Revised) and proposed ISA 701. The CAG Working Group (and some respondents) asked whether the ISAs cover, for example, auditors' reports on historical financial information that reflect the utilization of funds received from donor organizations. Referring to the examples of a single financial statement and examples of a specific element, account or item of a financial statement in Appendix 1 to ED-ISA 701, the Task Force was of the view that such auditors' reports are covered by the ISAs.
26. However, the Task Force also considered the scopes of ED-ISA 701 and International Standard on Assurance Engagements⁴ (ISAE) 3000, "Assurance Engagements Other than Audits or Reviews of Historical Financial Information." The Task Force is of the view that the confusion is created by differences in view of the meaning of the term "historical financial information." The significance of the term is for the cut between the ISAs (historical financial information) and the ISAEs (other information). Rather than change this distinction, it may be preferable to decide where the IAASB want that cut to be, and to define "historical financial information" accordingly. Possibilities might include:

⁴ According to the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," International Standards on Auditing (ISAs) are to be applied in the audit of historical financial information and International Standards on Assurance Engagements (ISAEs) are to be applied in assurance engagements dealing with subject matters other than historical financial information.

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- All information of a financial nature that is historical. This would apply the ISAs to everything that is expressed in financial terms (e.g., an audit opinion on average share prices, or asset values).
- Information derived primarily from an entity's accounting system – irrespective of its form (e.g., information about expenditure in pursuance of a contract or project, such as is often required by a grant provider).
- Information included in financial statements. This would restrict the definition to information actually appearing in financial statements.

It seems unlikely to the Task Force that the first option was envisaged by the IAASB when approving the scope of ISAE 3000 as compared with the scope of the ISAs. The third option may be thought too narrow, and so the Task Force is inclined to favor the second option.

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Material Presented – FOR REFERENCE PURPOSES ONLY

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| Agenda Item J.1 | Proposed Changes to ISA 200, “Objectives and General Principles Governing an Audit of Financial Statements” (May 2006 IAASB Agenda Item 2-A) |
| Agenda Item J.2 | Exposure Draft of Proposed ISA 701, “The Independent Auditor’s Report on Other Historical Financial Information” |

The remainder of the May 2006 IAASB meeting material is available from <http://www.ifac.org/IAASB/Meeting-BGPapers.php?MID=0065>.