



Agenda Item 6

Auditor Reporting — Cover Letter and Issue Paper

Objective

To discuss certain elements of the auditor's report relating to ASB's convergence with the International Auditing and Assurance Standards Board (IAASB) International Standards on Auditing (ISA) 700 (Revised) *Forming an Opinion and Reporting on Financial Statements* and the proposed way forward on guidance for the communication of key audit matters.

Task Force

The Auditor Reporting Task Force (task force) members are:

- Dan Montgomery (Chair)
- Jan Herringer
- Susan Jones
- Richard Miller
- Marc Panucci
- Jeffrey Rapaglia
- Rick Reisig
- Mike Westervelt (TIC)

Background

In 2015 the IAASB issued new and revised ISAs relating to reporting on audited financial statements. The following is a list of the new and revised ISAs, which are effective for audits of financial statements for periods ending on or after December 15, 2016.

- ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*
- ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*
- ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*
- ISA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*
- ISA 720 (Revised) *The Auditor's Responsibilities Relating to Other Information*
- ISA 570 (Revised), *Going Concern*
- ISA 800 (Revised), *Special Considerations — Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*

- ISA 805 (Revised), *Special Considerations — Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*, and ISA 810 (Revised), *Engagements to Report on Summary Financial Statements*

At the January 2016 ASB meeting, the ASB discussed certain threshold issues relating to ASB's stated goal of convergence with the new and revised ISAs while also considering the standards of the Public Company Accounting Oversight Board (PCAOB). Two consistent themes in discussing each issue were the need for outreach and communication with stakeholders, and the need for a framework for the task force and ASB in determining how to converge with the ISAs while also considering the PCAOB standards.

At the May 2016 ASB meeting, the ASB discussed certain elements of the auditor's report relating to the ASB's convergence with ISA 700 and a framework to help the task force with convergence. The ASB's discussion focused on the task force's suggested wording of the requirements in ISA 700 relating to the elements of the auditor's report as a starting point for proposed revisions to AU-C 700.

PCAOB Update

On May 11, 2016 the PCAOB released, for public comment, a reproposal of their auditor reporting standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, with comments due by August 15, 2016. The reproposal retains the pass/fail model of the existing auditor's report. The reproposal includes a requirement for the auditor's report to include "critical audit matters," which would provide audit-specific information about especially challenging, subjective, or complex aspects of the audit as they relate to the relevant financial statement accounts and disclosures.

In addition to critical audit matters, the reproposal contains other improvements to the existing auditor's report intended to clarify the auditor's role and responsibilities related to the audit of the financial statements and make the auditor's report easier to read. Such changes include:

- *Independence*—include a statement regarding the requirement for the auditor to be independent
- *Auditor Tenure*—include a statement regarding the auditor's tenure
- *Addressee*—include a requirement to address the auditor's report to the company's shareholders and board of directors or equivalents, and expressly permit additional addressees
- *Enhancements to basic elements*—enhance certain standardized language in the auditor's report, including adding the phrase "whether due to error or fraud," when describing the auditor's responsibility under PCAOB standards to obtain reasonable assurance about whether the financial statements are free of material misstatements
- *Standardized form of the auditor's report*—require the opinion to be the first section of the auditor's report and require section titles to guide the reader

Subsequent Task Force Discussion

Subsequent to the May 2016 ASB meeting, the task force held a one-day meeting to consider the ASB's feedback from the May meeting and revise its suggested wording for proposed AU-C 700 to converge with ISA 700, while also considering the PCAOB's reproposal. Further, the task force discussed key audit matters and the similarities and differences between key audit matters (IAASB) and critical audit matters (PCAOB).

Agenda Items Presented

- Item 6 – Cover Letter and Issues Paper
- Item 6A – Matrix of reporting elements (ISA 700 Revised (clean) / ISA 700 Revised (marked for proposed wording) / Extant AU-C 700 (marked for proposed wording)
- Item 6B – Illustrative report – ISA 700 (Revised)
- Item 6C – Illustrative report – Proposed AU-C 700
- Item 6D – Illustrative report – PCAOB reproposal
- Item 6E – Illustrative report – ISA 700 Revised (marked to proposed AU-C 700)
- Item 6F – KAM Overview Diagram
- Item 6G – CAM Overview Diagram

Issues for ASB discussion

Issue 1 — Key Audit Matters/Critical Audit Matters

ISA 700 (Revised) requires the auditor to communicate key audit matters (KAM) in the auditor's report for audits of complete sets of general purpose financial statements for listed entities. ISA 700 (Revised) also requires the auditor to communicate KAM in accordance with ISA 701 when otherwise required by law or regulation or when the auditor decides to do so. Key audit matters are those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance. The application material to ISA 700 (Revised) says the auditor may decide to communicate KAM for other entities, including those that may be of significant public interest, for example because they have a large number and wide range of stakeholders and considering the nature and size of the business. Examples include banks, insurance companies, and pension funds, and other entities such as charities.¹ The ISA also states that public sector entities may be significant due to size, complexity or public interest

¹ ISA 700, *Forming an Opinion and Reporting on Financial Statements*, paragraph .A41

aspects. In such cases, an auditor of a public sector entity may be required by law or regulation or may otherwise decide to communicate KAM.

The PCAOB reproposal requires the auditor's report to include the communication of critical audit matters (CAM) relating to the audit of the current period's financial statements. CAM is defined as any matter that was communicated or required to be communicated to the audit committee that (a) relates to accounts or disclosures that are material to the financial statements, and (b) involved especially challenging, subjective, or complex auditor judgment. CAM is not required for audits of brokers and dealers reporting under Exchange Act Rule 17a-5; investment companies registered under the Investment Company Act of 1940, other than companies that have elected to be regulated as business development companies; and employee stock purchase, savings, and similar plans.

Consistent with the discussion at the January 2016 ASB meeting, the task force supports developing a proposed standard to create a framework in GAAS to provide guidance for auditors of nonissuers when the auditor decides, or is required, to communicate key audit matters. The task force notes that the PCAOB reproposal states that "Although the processes of identifying these matters would vary across jurisdictions, there are commonalities in the underlying criteria regarding matters to be communicated and the communication requirements, such that expanded auditor reporting could result in the communication of many of the same matters under the various approaches." The IAASB has acknowledged the similarities between its concept of KAM and the PCAOB's model for CAM, and also believes that the same types of matters would be communicated under either approach. The task force agrees and therefore supports convergence with ISA 701 *Communicating Key Audit Matters in the Independent Auditor's Report*.

The attached diagrams in agenda items 6F and 6G illustrate the approaches and principal considerations for determining and communicating key audit matters and critical audit matters, respectively. The diagrams have been provided for informational purposes to help the ASB see the similarities between the two models.

Action Requested of the ASB

The ASB is asked to consider these diagrams for discussion at the ASB meeting.

Issue 2 — Illustrative Reports

When considering how best to converge with ISA 700 (Revised) while also considering the standards of the PCAOB, the task force found it helpful to consider an illustrative auditor's report under ISA 700 (Revised) and compare that report to a proposed AU-C 700 report that would converge with ISA 700. The task force also compared the proposed AU-C 700 report to the illustrative auditor's report under the PCAOB reproposal, noting the similarities and differences. Overall, the task force unanimously supports convergence with ISA 700 (Revised),

while retaining certain wording from AU-C 700 (for example, for conventions and terminology in the United States).

These illustrative reports are presented as Agenda Items 6B, 6C, 6D, and 6E.

Action Requested of the ASB

The ASB is asked to consider the illustrative reports for discussion at the ASB meeting.

Issue 3 — Report Elements

Agenda item 6A contains a matrix that reflects the task force's proposed changes to extant AU-C 700 to reflect convergence with ISA 700. The matrix also shows the differences between the proposed AU-C 700 wording and ISA 700 (Revised). The task force considered the PCAOB reproposal and whether the differences between ISA 700 (Revised) and the PCAOB reproposal necessitated a change from the ISA 700 (Revised) wording. As noted above, the task force's consensus was to continue to converge with ISA 700 (Revised) to the fullest extent possible.

Action Requested of the ASB

The ASB is asked to review the matrix for discussion at the ASB meeting.