Proposals to Enhance the Auditor’s Report

AICPA staff has issued this brief to provide you with information about the ongoing projects of the International Auditing and Assurance Standards Board (IAASB) and the Public Company Accounting Oversight Board (PCAOB) related to enhancing auditor reporting. This brief is for informational purposes only and does not constitute an authoritative or official pronouncement of the AICPA Auditing Standards Board (ASB).

**Background — Auditor Reporting**

**AICPA Auditing Standards Board**

The mission of the ASB is to serve the public interest by developing, updating, and communicating comprehensive standards and practice guidance that enable practitioners to provide high-quality, objective audit and attestation services to nonissuers in an effective and efficient manner.

In 2004 the ASB considered how best to effectively meet its mission in light of the creation of the PCAOB, which oversees the audits of public companies, and the increasingly widespread acceptance of the International Standards on Auditing (ISAs) issued by the IAASB. The IAASB serves the public interest by setting auditing, assurance, and other related standards and by facilitating the convergence of international and national auditing and assurance standards.

The ASB’s first step was to develop a plan to harmonize U.S. generally accepted auditing standards with the ISAs while avoiding the creation of unnecessary differences with PCAOB standards. As part of the harmonization process, the ASB aligned its agenda with that of the IAASB. In most circumstances, ASB standards will be developed concurrently with new ISAs. This allows the ASB to deliberate contemporaneously on the same projects as the IAASB and therefore to comment more effectively on the proposed ISAs. The intention of the ASB is that there will be very few, if any, differences between the requirements of the ISAs and the Statements on Auditing Standards (SASs). Differences in explanatory material would typically pertain to U.S. specific circumstances.

As a result, it is important for auditors in the United States to also monitor the activities of the IAASB and be aware of this current project because the ASB is committed to harmonizing its standards with the ISAs. However, because the adoption of the AICPA clarified auditing standards are just now being implemented, including enhancements to the auditor’s reports for nonissuers, the ASB has decided to deliberate further changes to the auditor’s report once the IAASB’s project is closer to final.

**IAASB Auditor Reporting Exposure Draft**

In July 2013 the IAASB issued the exposure draft *Reporting on Audited Financial Statements: Proposed New and Revised International Standards on Auditing* (ISAs) to enhance auditor reporting globally. The exposure draft notes that the proposals are a response to calls from investors, analysts, and other users of audited financial statements in the wake of the global financial crisis for the auditor to provide more relevant information in the auditor’s report.
The exposure draft proposes a new auditing standard, ISA 701, *Communicating Key Audit Matters in the Independent Auditor’s Report*, which, as proposed, would be required only for audits of financial statements of listed entities. In addition to the identification and disclosure of key audit matters, the proposed revisions include (a) the addition of new required elements in the auditor’s report related to the auditor’s assessment of going concern and affirmation of auditor independence; (b) reporting on other information (to be finalized as part of the separate project to revise ISA 720 The Auditor’s Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements); (c) disclosure of the name of the engagement partner (for listed entities); (d) revised descriptions of the responsibilities of the auditor and key features of the audit; and (e) although not required, prominent placement of the auditor’s opinion and other entity-specific information in the auditor’s report. The auditor’s communication of key audit matters would be required for listed entities but are permitted to be included for other than listed entities. All other changes, except for the disclosure of the name of the engagement partner, are required for all entities. Example reports illustrating various key audit matters are included in the proposed ISAs.

The exposure draft is open for public comment through November 22, 2013 and AICPA members are encouraged to review and provide the IAASB with comments specific to observations and concerns of the potential effects the proposed standards may have on auditor reporting in the United States. See appendix A for a summary of the key enhancements being proposed by the IAASB and appendix B for an illustration of the proposed auditor’s report.

**PCAOB Exposure Draft**

In August 2013, the PCAOB released for public comment *PCAOB Release No. 2013-005, The Auditor’s Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; The Auditor’s Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and The Related Auditor’s Report; and Related Amendments to PCAOB Standards*. The proposal includes a new auditing standard and related amendments to enhance the auditor’s reporting model. The proposed standard would provide additional information to investors and other financial statement users about the audit and the auditor.

The proposed auditor reporting model requires (a) the communication of critical audit matters as determined by the auditor; (b) the addition of new elements to the auditor’s report related to auditor independence, auditor tenure, and the auditor’s responsibilities for, and the results of, the auditor’s evaluation of other information outside the financial statements; and, (c) enhancements to existing language in the auditor’s report related to the auditor’s responsibilities for fraud and notes to the financial statements. The exposure document is open for public comment through December 11, 2013. See appendix B for an illustration of the proposed auditor’s report.

**Comparison of PCAOB and IAASB Proposals**

In many respects, the PCAOB proposal is similar to that of the IAASB in that they both retain the pass/fail model and the basic elements of the current auditor’s report, and would require the auditor to communicate a wider range of information specific to the particular audit. They also both would require the auditor to make a statement about the auditor’s independence.

While similar, the two proposals differ in some important respects. The following section identifies some of the more significant differences between the two proposals. Also see appendix A for a more detailed comparison.

**Going Concern**

The IAASB proposal requires a “going concern” section in the auditor's report which addresses the auditor’s conclusions related to whether (1) management’s use of the going concern basis of accounting in the preparation of the financial statements is appropriate and (2) whether a material uncertainty exists related to events or conditions that, individually or collectively, may cast significant doubt on the entity’s ability to continue as a going concern.

The PCAOB will address Going Concern as part of a separate project.

**Key Audit Matters / Critical Audit Matters**

Under the IAASB proposal, the population of matters used to select Key Audit Matters (KAM) is based on the communications to those charged with governance. KAM are only required to be included in auditor’s reports for listed entities; they would be permitted in auditor’s reports for non-listed entities.

Under the PCAOB proposal, the population of matters used to select critical audit matters may go beyond those matters communicated with those charged with governance because they ordinarily are matters of such importance that they are
included in the matters required to be (1) documented in the engagement completion document; (2) reviewed by the engagement quality reviewer; (3) communicated to the audit committee; or (4) any combination thereof.

Expanded Sections and Preferred Ordering of the Elements in the Auditor’s Report

The IAASB proposal includes expanded sections about the auditor’s and management’s responsibilities and allows for flexibility in the ordering of the elements of the report. While specific ordering is not mandated, the proposal includes a preferred placement of the required auditor reporting elements, including placement of the opinion paragraph first.

The PCAOB proposal does not expand management’s responsibilities, but does include additional wording relating to the auditor’s responsibilities as they relate to material misstatements due to fraud. The proposed standard does not require that the basic elements appear in a specific order in the auditor’s report, nor does it require that section titles be included, except for the section titles regarding the auditor’s responsibilities for other information and critical audit matters. The proposed standard requires certain placement for the critical audit matters, explanatory paragraphs, and the other information section in the report and does not preclude the auditor from including section titles for other sections in the auditor’s report.

Engagement Partner Name

The IAASB proposal would require disclosure of the name of the engagement partner in the audit report for audits of financial statements of listed entities, unless in rare circumstances, such a disclosure is reasonably expected to lead to a significant security threat to the individual.

The PCAOB is considering separate rulemaking related to the identification of the engagement partner in the auditor’s report.

Auditor Independence

The IAASB proposal requires the auditor to include in the auditor’s report an explicit statement that the auditor is independent of the audited entity (within the meaning of the relevant ethical requirements or applicable law) and has fulfilled its responsibilities under those ethical requirements (with disclosure of the source[s] of those requirements) and states that the auditor exercises professional judgment and maintains professional skepticism throughout the planning and performance of the audit.

The PCAOB proposal requires the auditor to include a statement in the auditor’s report that the auditor is a public accounting firm registered with the PCAOB (United States) and is required to be independent with respect to the company in accordance with the United States federal securities laws and the applicable rules and regulations of the SEC and the PCAOB.

The PCAOB proposal is simply a statement that the auditor is required to be independent whereas the IAASB proposal contains a more positive statement about the auditor’s independence.

Auditor Tenure

The PCAOB proposal requires a statement to be included in the auditor’s report containing the year the auditor (audit firm) began serving consecutively as the company’s auditor.

The IAASB does not have a similar proposal.

Next Steps

The ASB has been providing regular input to the IAASB project, including providing a comment letter to the IAASB, dated September 16, 2011, on its Consultation Paper: Enhancing the Value of Auditor Reporting: Exploring Options for Change and a comment letter to the IAASB, dated October 8, 2012, on its Invitation to Comment: Improving the Auditor’s Report. The ASB plans to provide a comment letter to the IAASB on its current exposure draft Reporting on Audited Financial Statements: Proposed New and Revised International Standards on Auditing (ISAs). The ASB also plans to deliberate the new proposals to determine whether they are appropriate for nonissuer audit engagements in the U.S. environment, while minimizing differences from the PCAOB.
## Appendix A — Comparison of Auditor Reporting Proposals

<table>
<thead>
<tr>
<th>Pass/Fail Model</th>
<th><strong>IAASB Exposure Draft</strong></th>
<th>Comments Due</th>
<th><strong>PCAOB Exposure Draft</strong></th>
<th>Comments Due</th>
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<tbody>
<tr>
<td></td>
<td>Retains pass/fail model</td>
<td>November 22, 2013</td>
<td>Retains pass/fail model</td>
<td>December 11, 2013</td>
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<tr>
<td>Key Audit Matters (IAASB) [Required for Listed Entities]</td>
<td>Key Audit Matters (KAM) <strong>[Proposed ISA 701]</strong></td>
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<td>Critical Audit Matters (CAM) <strong>[Proposed New Auditing Standard]</strong></td>
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<td><strong>Critical Audit Matters (PCAOB)</strong></td>
<td>Matters that, in the auditor’s professional judgment, were of most significance in the audit of the financial statements of the current period.</td>
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<td>Those matters the auditor addressed during the audit of the financial statements that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate audit evidence; or (3) posed the most difficulty to the auditor in forming an opinion on the financial statements. Relates to current period however when the current period is presented on a comparative basis with those of one or more prior periods, the auditor also considers communicating CAM relating to the prior periods when (1) the prior period’s financial statements are made public for the first time, or (2) issuing an auditor’s report on the prior period’s financial statements because the previously issued auditor’s report could no longer be relied upon.</td>
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<td>Determining KAM</td>
<td>Selected from matters communicated with those charged with governance, taking into account areas of significant auditor attention including:</td>
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<td>Determining CAM</td>
<td>Ordinarily are matters of such importance that they are included in the matters required to be (1) documented in the engagement completion document; (2) reviewed by the engagement quality reviewer; (3) communicated to the audit committee; or (4) any combination thereof.</td>
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<td>Areas identified as significant risks in accordance with ISA 315 or involved significant auditor judgment</td>
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<td>Factors to take into account:</td>
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<td>Areas in which the auditor encountered significant difficulty during the audit, including with respect to obtaining sufficient appropriate audit evidence</td>
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<td>Degree of subjectivity involved in determining or applying audit procedures to address the matter or in evaluating the results of those procedures;</td>
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<td>Circumstances that required significant modification of the auditor’s planned audit approach, including as a result of the identification of a significant deficiency in internal control.</td>
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<td>The nature and extent of audit effort required to address the matter;</td>
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<td>The nature and amount of available relevant and reliable evidence regarding the matter or the degree of difficulty in obtaining such evidence;</td>
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<td>The severity of control deficiencies identified relevant to the matter, if any;</td>
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<td>The degree to which the results of audit procedures to address the matter resulted in changes in the auditor’s risk assessments, including risks that were not identified previously, or required changes to planned audit procedures, if any.</td>
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<td>IAASB Exposure Draft</td>
<td>PCAOB Exposure Draft</td>
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<td><strong>Describing KAM</strong></td>
<td><strong>Describing CAM</strong></td>
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<td>An explanation of why the auditor considered the matter to be one of most significance in the audit and, to the extent the auditor considers it necessary as part of this explanation, its effect on the audit; and A reference to the related disclosure(s), if any, in the financial statements.</td>
<td>The considerations that led the auditor to determine that the matter is a CAM; and A reference to the relevant financial statement accounts and disclosures that relate to the critical audit matter, when applicable.</td>
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<td><strong>No KAM</strong></td>
<td><strong>No CAM</strong></td>
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<td>If the auditor determines there are no KAM to communicate the auditor is required to: Discuss this conclusion with the engagement quality control reviewer Communicate this conclusion with TCWG Explain in the auditor’s report what the KAM section is intended to do and that the auditor has determined that there are no matters to report</td>
<td>The auditor should state that the auditor determined that there are no CAM.</td>
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<td><strong>Audit Documentation</strong></td>
<td><strong>Audit Documentation</strong></td>
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<td>Matters that will be communicated as KAM and the significant professional judgments made in reaching this determination (in accordance with ISA 260). This includes the rationale for the auditor’s determination that there are no KAM to communicate.</td>
<td>The determination of CAM. AS 3 requires audit documentation to be prepared in such detail to provide a clear understanding of its purpose, source, and the conclusions reached. For the determination of CAM the audit documentation must contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the basis for the auditor’s determination that (1) each reported matter was a CAM and (2) non-reported audit matters addressed in the audit that would appear to meet the definition of a CAM were not CAMs.</td>
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<td>Other Considerations</td>
<td>Other Considerations</td>
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<td>KAM is precluded with a disclaimer of opinion. Auditors of financial statements of entities other than listed entities may decide to communicate KAM in the auditor’s report. If so, they are required to apply proposed ISA 701.</td>
<td>CAM is not required with an adverse or disclaimer of opinion. Not applicable.</td>
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<th>Emphasis of Matters / Other Matters</th>
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<td>ISA 706 will retain the notion of EOM and OM paragraphs however those paragraphs would only be used to communicate matters that are not considered KAM. The proposed standard clarifies the relationship between EOM and OM paragraphs and the KAM section of the report.</td>
<td>The proposed auditor reporting standard would retain the auditor’s ability to add an explanatory paragraph to emphasize a matter regarding the financial statements. This explanatory paragraph refers only to information presented or disclosed in the financial statements. The proposed standard would potentially allow for the same matter to be discussed in CAM and an explanatory paragraph.</td>
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<th>Going Concern</th>
<th>Going Concern</th>
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<td>The ED proposes revisions to ISA 570 that require a “going concern” section of the auditor’s report which addresses the auditor’s conclusions related to whether (1) management’s use of the going concern basis of accounting in the preparation of the financial statements is appropriate and (2) whether a material uncertainty exists related to events or conditions that, individually or collectively, may cast significant doubt on the entity’s ability to continue as a going concern.</td>
<td>Not applicable - the PCAOB is considering a separate standard-setting project to enhance auditor performance requirements and auditor reporting related to a company’s ability to continue as a going concern.</td>
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<th>Other Information</th>
<th>Other Information</th>
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<td>Respondents to the IAASB’s previous consultation on OI generally supported improved reporting, but many criticized the proposed expansion of the auditor’s responsibilities beyond what can be accomplished in the context of a financial statement audit. The IAASB is in the process of considering these comments and has included a placeholder for this reporting in the ED.</td>
<td>Addresses auditor’s responsibilities for OI to a company’s annual report filed with the SEC. Requires the auditor to evaluate the OI for a material inconsistency with amounts or information, or the manner of their presentation, in the audited financial statements (material inconsistency); or a material misstatement of fact; or both and if so, to respond appropriately. Requires communication in the auditor’s report regarding the auditor’s responsibilities for OI and whether, based on relevant audit evidence obtained and conclusions reached during the audit, the OI contains a material inconsistency, a material misstatement of fact, or both. Adds procedures for the auditor to perform in evaluating OI based on relevant audit evidence obtained and conclusions reached during the audit. Illustrative report language:</td>
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| **Independence** | **IAASB Exposure Draft** | Include a statement that the auditor is independent of the audited entity (within the meaning of the relevant ethical requirements or applicable law) and has fulfilled its responsibilities under those ethical requirements. State that the auditor exercises professional judgment and maintains professional skepticism throughout the planning and performance of the audit.  
**Illustration**  
**Basis for Opinion**  
... We are independent of the Group within the meaning of [indicate relevant ethical requirements or applicable law or regulation] and have fulfilled our other responsibilities under those ethical requirements. ... |
| **PCAOB Exposure Draft** | Include a statement that the auditor is a public accounting firm registered with the PCAOB (United States) and is required to be independent with respect to the company in accordance with the United States federal securities laws and the applicable rules and regulations of the SEC and the PCAOB.  
**Illustration (Introduction)**  
We are a public accounting firm registered with the Public Company Accounting Oversight Board ("PCAOB") (United States) and are required to be independent with respect to the Company in accordance with the United States federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission ("SEC") and the PCAOB. We or our predecessor firms have served as the Company’s auditor consecutively since [year]. |
| **Auditor Tenure** | **IAASB Exposure Draft** | Not applicable. |
| **PCAOB Exposure Draft** | Requirement to include a statement containing the year the auditor began serving consecutively as the company’s auditor.  
**Illustration**  
... We or our predecessor firms have served as the Company’s auditor consecutively since [year]. |
<p>| <strong>Name of the Engagement Partner</strong> | <strong>IAASB Exposure Draft</strong> | Disclosure of the name of the engagement partner in the audit report for audits of financial statements of listed entities unless, in rare circumstances, such disclosure is reasonably expected to lead to a significant security threat to the individual. |
| <strong>PCAOB Exposure Draft</strong> | Not applicable – the PCAOB is considering on a separate docket whether to require engagement partner identification in the auditor’s report. |
| <strong>Responsibilities of</strong> | <strong>IAASB Exposure Draft</strong> | Proposed revisions to ISA 700 include |
| <strong>PCAOB Exposure Draft</strong> | The PCAOB proposal includes additional wording relating to |</p>
<table>
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<th><strong>the Auditor</strong></th>
<th>IAASB Exposure Draft</th>
<th>PCAOB Exposure Draft</th>
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<td>revised description of the responsibilities of the auditor and key features of the audit (together with provisions for certain components of this description to be allowed to be relocated to an appendix to the auditor’s report, or for reference to be made to such description on the website of an appropriate authority).</td>
<td>the auditor’s responsibilities as it relates to fraud and risk assessment. The proposal does not allow the auditor responsibilities to be relocated from the report.</td>
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| **Communication With Those Charge With Governance/Audit Committees** | Proposed revisions to ISA 260 includes amendments to the required auditor communications with those charged with governance to include communication about the significant risks identified by the auditor, and circumstances that required significant modification of the auditor’s planned approach to the audit, in light of proposed ISA 701. | The PCAOB proposes a change to AS 16 that requires the auditor to provide to and discuss with the audit committee a draft of the auditor’s report. |

<p>| <strong>Ordering of the Elements</strong> | Ordering of the elements is not mandated, however the IAASB has intentionally presented the requirements in a particular order that also aligns with the suggested presentation in the illustrative reports. The IAASB has agreed to require specific headings in the auditor’s report to ensure the required reporting elements can be recognized in all reports for audits conducted in accordance with the ISAs, even if they are presented in a different order from that of the illustrative auditor’s reports. The IAASB has not included any guidance or illustration to suggest an alternative presentation to encourage consistency in presentation. The exposure draft illustrates the following order: Opinion Basis for Opinion KAM Going Concern Other Information Responsibilities of Management and Those Charged with Governance for the Financial Statements Auditor’s Responsibilities for the Audit of the Financial Statements | Requires basic elements to be included but does not mandate the ordering other than in certain instances related to CAM and for departures from unqualified opinions. For example, the ED requires a section titled “Critical Audit Matters” and requires certain standardized language to precede the critical audit matters communicated in the auditor’s report. The CAM section follows the Opinion on the Financial Statements section and any explanatory paragraphs. In addition, an explanatory paragraph follows the Opinion paragraph on the financial statements section, unless otherwise required by other standards of the PCAOB. The Auditor’s Responsibilities regarding Other Information section follows the Opinion on the Financial Statements section, any explanatory paragraphs, and the Critical Audit Matters section. For qualified or adverse opinions a separate “basis for departure from an unqualified opinion paragraph” should precede the opinion paragraph. The exposure draft illustrates the following order: Introduction Basis of Opinion Opinion CAM The Auditor’s Responsibilities Regarding Other Information |</p>
<table>
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<th>IAASB Exposure Draft</th>
<th>PCAOB Exposure Draft</th>
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<tr>
<td>Report on Other Legal and Regulatory Requirements</td>
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<td><strong>Modifications to the Opinion</strong></td>
<td>Proposed amendments are made to ISA 705 to clarify how the new required reporting elements of proposed ISA 700 are affected when the auditor expresses a modified opinion, and to update the illustrative auditor’s reports accordingly.</td>
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Appendix B – Illustrative Auditor’s Reports

Note: This appendix contains illustrations of the auditor’s report under the IAASB and PCAOB proposals, respectively. The IAASB illustration is a clean version that includes the preferred ordering of the elements of the report, new content, and illustrations of key audit matters. The PCAOB illustration is redlined to the extant report to highlight where the PCAOB is proposing changes and does not include the illustrations of critical audit matters in the report. Rather, the PCAOB included illustrations of critical audit matters in a separate appendix in the proposal. Those illustrations of critical audit matters have been included at the end of this appendix. These illustrations have been reproduced based on the IAASB and PCAOB exposure documents. The IAASB exposure document contains additional illustrations, including modified opinions that are not included here.

The following is the illustration of the auditor’s report from the IAASB exposure draft.

INDEPENDENT AUDITOR’S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

Report on the Audit of the Consolidated Financial Statements

Opinion

In our opinion, the accompanying consolidated financial statements present fairly, in all material respects, (or give a true and fair view of) the consolidated financial position of ABC Company and its subsidiaries (the Group) as at December 31, 20X1, and (of) their consolidated financial performance and their consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

We have audited the consolidated financial statements of the Group, which comprise the consolidated statement of financial position as at December 31, 20X1, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the Auditor’s Responsibilities for the Audit of the Consolidated Financial Statements section of our report. We are independent of the Group within the meaning of [indicate relevant ethical requirements or applicable law or regulation] and have fulfilled our other responsibilities under those ethical requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters [Required for Listed Entities]

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the consolidated financial statements. Key audit matters are selected from the matters communicated with [those charged with governance], but are not intended to represent all matters that were discussed with them. Our audit procedures relating to these matters were designed in the context of our audit of the consolidated financial statements as a whole. Our opinion on the consolidated financial statements is not modified with respect to any of the key audit matters described below, and we do not express an opinion on these individual matters.

The four specific topics and content presented below are purely for illustrative purposes. This section would be tailored to the facts and circumstances of the individual audit engagement and the entity. Accordingly, the IAASB has intentionally drafted these examples in a manner that illustrates that Key Audit Matters will vary in terms of the number and selection of topics addressed and the nature in which they may be described, and are intended to be consistent with the disclosures in the entity’s consolidated financial statements.

Goodwill

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1 The sub-title “Report on the Audit of the Consolidated Financial Statements” is unnecessary in circumstances when the second sub-title “Report on Other Legal and Regulatory Requirements” is not applicable.
Under IFRSs, the Group is required to annually test the amount of goodwill for impairment. This annual impairment test was significant to our audit because the assessment process is complex and highly judgmental and is based on assumptions that are affected by expected future market or economic conditions, particularly those in [Countries X and Y]. As a result, our audit procedures included, among others, using a valuation expert to assist us in evaluating the assumptions and methodologies used by the Group, in particular those relating to the forecasted revenue growth and profit margins for [name of business lines]. We also focused on the adequacy of the Group’s disclosures about those assumptions to which the outcome of the impairment test is most sensitive, that is, those that have the most significant effect on the determination of the recoverable amount of goodwill. The Group’s disclosures about goodwill are included in Note 3, which specifically explains that small changes in the key assumptions used could give rise to an impairment of the goodwill balance in the future.

Valuation of Financial Instruments

The Group’s disclosures about its structured financial instruments are included in Note 5. The Group’s investments in structured financial instruments represent [x%] of the total amount of its financial instruments. Because the valuation of the Group’s structured financial instruments is not based on quoted prices in active markets, there is significant measurement uncertainty involved in this valuation. As a result, the valuation of these instruments was significant to our audit. The Group has determined it is necessary to use an entity-developed model to value these instruments, due to their unique structure and terms. We challenged management’s rationale for using an entity-developed model, and discussed this with [those charged with governance], and we concluded the use of such a model was appropriate. Our audit procedures also included, among others, testing management’s controls related to the development and calibration of the model and confirming that management had determined it was not necessary to make any adjustments to the output of the model to reflect the assumptions that marketplace participants would use in similar circumstances.

Acquisition of XYZ Business

As described in Note 2, in December 20X1, the Group completed the acquisition of XYZ Business. XYZ Business was a division of a large private company. As of December 31, 20X1, the Group has completed the initial acquisition accounting on a preliminary basis. The Group will finalize the initial acquisition accounting during 20X2, and the amounts recorded as of December 31, 20X1 could change. We focused on this transaction because it is material to the consolidated financial statements as a whole and the fact that values had not previously been assigned to the division as a standalone operation. In addition, determining the assumptions that underlie the initial acquisition accounting and the useful lives associated with the acquired intangible assets involves significant management judgment given the nature of the [name of industry].

Revenue Recognition Relating to Long-Term Contracts

The terms and conditions of the Group’s long-term contracts in its [name of segment] affect the revenue that the Group recognizes in a period, and the revenue from such contracts represents a material amount of the Group’s total revenue. The process to measure the amount of revenue to recognize in the [name of industry], including the determination of the appropriate timing of recognition, involves significant management judgment. We identified revenue recognition of long-term contracts as a significant risk requiring special audit consideration. This is because side agreements may exist that effectively amend the original contracts, and such side agreements may be inadvertently unrecorded or deliberately concealed and therefore present a risk of material misstatement due to fraud. In addition to testing the controls the Group has put in place over its process to enter into and record long term contracts and other audit procedures, we considered it necessary to confirm the terms of these contracts directly with customers and testing journal entries made by management related to revenue recognition. Based on the audit procedures performed, we did not find evidence of the existence of side agreements. The Group’s disclosures about revenue recognition are included in the summary of significant accounting policies in Note 1, as well as Note 4.

Going Concern

The consolidated financial statements of the Group have been prepared using the going concern basis of accounting. The use of this basis of accounting is appropriate unless management either intends to liquidate the Group or to cease operations, or has no realistic alternative but to do so. As part of our audit of the consolidated financial statements, we have concluded that management’s use of the going concern basis of accounting in the preparation of the Group’s consolidated financial statements is appropriate. Management has not identified a material uncertainty that may cast significant doubt on the Group’s ability to continue as a going concern, and accordingly none is disclosed in the consolidated financial statements of the Group. Based on our audit of the consolidated
financial statements of the Group, we also have not identified such a material uncertainty. However, neither management nor the auditor can guarantee the Group’s ability to continue as a going concern.

Other Information

[The illustrative wording for this section is subject to the IAASB’s finalization of proposed ISA 720 (Revised). The content of this section may include, among other matters: (a) a description of the auditor’s responsibilities with respect to other information; (b) identification of the document(s) available at the date of the auditor’s report that contain the other information to which the auditor’s responsibilities apply; (c) a statement addressing the outcome of the auditor’s work on the other information; and (d) a statement that the auditor has not audited or reviewed the other information and, accordingly, does not express an audit opinion or a review conclusion on it.]

Responsibilities of [Management\(^2\) and Those Charged with Governance or other appropriate terms] for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with IFRSs,\(^3\) and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error. [Those charged with governance] are responsible for overseeing the Group’s financial reporting process.

Auditor’s Responsibilities for the Audit of the Consolidated Financial Statements

The objectives of our audit are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor’s report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these consolidated financial statements.

[The remaining material in this section can be located in an Appendix to the auditor’s report (see paragraph 39 of proposed ISA 700 (Revised). When law, regulation or national auditing standards expressly permits, reference can be made to a website of an appropriate authority that contains the description of the auditor’s responsibilities, rather than including this material in the auditor’s report (see paragraph 40 of proposed ISA 700 (Revised)).]

As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit. We also:

- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity’s internal control.\(^4\)

- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.

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\(^2\) Throughout the illustrative auditor’s reports in the Proposed ISAs, the term management may need to be replaced by another term that is appropriate in the context of the legal framework in the particular jurisdiction. For example, those charged with governance, rather than management, may have these responsibilities.

\(^3\) Where management’s responsibility is to prepare financial statements that give a true and fair view, this may read: “Management is responsible for the preparation of consolidated financial statements that give a true and fair view in accordance with IFRSs, and for such ...”

\(^4\) This sentence would be modified, as appropriate, in circumstances when the auditor also has responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the consolidated financial statements.
• Evaluate the overall presentation, structure and content of the consolidated financial statements, including the disclosures, and whether the consolidated financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

• Obtain sufficient appropriate audit evidence regarding the financial information of the entities and business activities within the group to express an opinion on the consolidated financial statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion.

We are required to communicate with [those charged with governance] regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We are also required to provide [those charged with governance] with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

Report on Other Legal and Regulatory Requirements

[The form and content of this section of the auditor’s report would vary depending on the nature of the auditor’s other reporting responsibilities prescribed by local law, regulation, or national auditing standards. Depending on the matters addressed by other law, regulation or national auditing standards, national standard setters may choose to combine reporting on these matters with reporting as required by the ISAs (shown in the Report on the Audit of the Consolidated Financial Statements section), with wording in the auditor’s report that clearly distinguishes between reporting required by the ISAs and other reporting required by law or regulation.]

The engagement partner responsible for the audit resulting in this independent auditor’s report is [name]. [Required for Listed Entities]

[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]

[Auditor Address]

[Date]

The following is the illustration of the auditor’s report from the PCAOB exposure draft.

[Changes from the current illustrative report are underlined.]

Report of Independent Registered Public Accounting Firm

To the shareholders and board of directors of X Company

[Introduction]

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of operations, stockholders' equity, and cash flows, for each of the three years in the period ended December 31, 20X2, and the related notes (collectively referred to as the "financial statements"). These financial statements are the responsibility of the Company's management.

We are a public accounting firm registered with the Public Company Accounting Oversight Board ("PCAOB") (United States) and are required to be independent with respect to the Company in accordance with the United States federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission ("SEC") and the PCAOB. We or our predecessor firms have served as the Company's auditor consecutively since [year].

[Basis of Opinion]

Our responsibility is to express an opinion on the Company's financial statements based on our audits. We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud.
Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures include examining, on a test basis, appropriate evidence regarding the amounts and disclosures in the financial statements.

Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

[Opinion on the Financial Statements]

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 20X2, in conformity with [the applicable financial reporting framework].

Critical Audit Matters

The standards of the PCAOB require that we communicate in our report critical audit matters relating to the audit of the current period's financial statements or state that we determined that there are no critical audit matters. Critical audit matters are those matters addressed during the audit that (1) involved our most difficult, subjective, or complex judgments; (2) posed the most difficulty to us in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to us in forming our opinion on the financial statements. The critical audit matters communicated below do not alter in any way our opinion on the financial statements, taken as a whole.

[Include critical audit matters]*

The Auditor's Responsibilities Regarding Other Information

In addition to auditing the Company's financial statements in accordance with the standards of the PCAOB, we evaluated whether the other information, included in the annual report on [SEC Exchange Act form type] filed with the SEC that contains both the December 31, 20X2 financial statements and our audit report on those financial statements, contains a material inconsistency with the financial statements, a material misstatement of fact, or both. Our evaluation was based on relevant audit evidence obtained and conclusions reached during the audit. We did not audit the other information and do not express an opinion on the other information. Based on our evaluation, we have not identified a material inconsistency or a material misstatement of fact in the other information.

[Signature]

[City and State or Country]

[Date]

* See the section following this illustrative auditor's report for examples of critical audit matters.
**Illustrative Critical Audit Matters**

Hypothetical Illustration #1 — Allowance for Sales Returns

We determined that our evaluation of the Company’s allowance for sales returns was a critical audit matter in the audit of the Company’s financial statements as of and for the fiscal year ended January 31, 2013. The Company developed a new on-line sales channel. This new sales channel could have significantly different return experience than sales through its more established retail stores. In addition, the Company simultaneously lengthened its return policy. The Company developed new models with different assumptions to reflect these changes in its estimate of the allowance for sales returns, a key element in recording revenue. The lack of historical experience with the new assumptions resulted in a high degree of measurement uncertainty in estimating the allowance for sales returns.

Because of these changes in the Company’s distribution channel and sales return policy, our audit of the Company’s allowance for sales returns (1) involved our difficult and subjective judgments in evaluating whether the Company had a sufficient basis to make a reasonable estimate of sales returns and (2) posed difficulty to us in obtaining sufficient appropriate evidence to support management’s adjustments to the allowance for sales returns. We consulted with our national office on (1) the design and performance of audit procedures to test the data underlying management’s assumptions used to estimate future sales returns and (2) our evaluation of the results of those procedures, including our assessment of the reasonableness of management’s judgments regarding the effect that changes in the Company’s return policies and practices, as well as changes in economic and buying trends that affect customer behavior, have on the estimate of future sales returns. The Company’s accounting policy for sales returns is discussed in Note 1 to the financial statements.

Hypothetical Illustration #2 — Valuation Allowance for Deferred Tax Assets

We determined that our assessment of the Company’s evaluation of the realizability of deferred tax assets was a critical audit matter in the audit of the Company’s financial statements for the fiscal year ended June 30, 2013. Considerations that led to our determination, included the following:

- The Company exercised significant judgment in weighing positive and negative evidence regarding the realizability of the company’s deferred tax assets, including in developing forecasts of projected future taxable income.
- The Company continues to experience increased competition with its “first generation” products which reduced revenue growth, sales prices and profitability. Further, the Company experienced an unexpected cost increase in a critical product component and does not anticipate that cost returning to historical levels;
- A return to profitability by the Company is dependent upon launching "next generation" products in the future; and
- The Company is experiencing increases in product development and marketing costs in preparation for its "next generation" products.

Because of these considerations, our assessment of the Company’s evaluation of the realizability of deferred tax assets: (1) involved subjective auditor judgments in evaluating whether management’s judgments regarding the weight given to positive and negative evidence is appropriate; (2) involved difficult auditor judgments in designing audit procedures to test the data underlying management’s forecasts of its future taxable income; (3) posed difficulty in obtaining sufficient appropriate evidence to support management’s forecasts of the timing and amount of future taxable income due to the lack of objective evidence; and (4) posed difficulty in forming an opinion on the financial statements because of the significance to the financial statements, taken as a whole, of the Company's determination regarding the recognition of a valuation allowance for its deferred tax assets.

We consulted with others outside the engagement team regarding: (1) compliance with U.S. GAAP; (2) the design and performance of audit procedures to test management’s forecasts; and (3) our evaluation of the results of those procedures, including our assessment of the reasonableness of management’s judgments and forecasts in light of independent assessments of future trends in the industry, analyst reports and publicly available information regarding relevant trends by key competitors. The Company’s accounting policy for deferred taxes and its evaluation of the realizability of deferred tax assets are discussed in Notes 2 and 12 to the financial statements.

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5 Illustration taken from Appendix 5 of the PCAOB Release No. 2013-005.
Hypothetical Illustration #3 — Fair Value of Fixed Maturity Securities Held as Investments That are Not Actively Traded

Approximately 35% of the Company's investment portfolio is comprised of private label mortgage-backed securities and collateralized loan obligations. Our audit of the Company's fair value of these securities in the audit of the Company's financial statements as of and for the fiscal year ended December 31, 2012 involved difficult and complex auditor judgments because these securities (1) trade less frequently and (2) were valued using in-house valuation models based on unobservable inputs, which are subject to a wide range of measurement uncertainty. Our audit of these securities required an extensive amount of audit work, including significant involvement of senior members of the engagement team and the involvement of a third party valuation specialist. Further, it was necessary to expand the planned audit procedures due to a control deficiency less severe than a material weakness noted in the Company's internal control system regarding fair value estimates, valued using in-house valuation models. Specifically, a control deficiency was determined relating to the controls employed by the pricing and valuation committee. Our audit procedures resulted in our identification of several misstatements that were corrected by the Company. The Company's disclosures related to nature and fair values of these securities and the methods the Company used to determine those fair values are in Note 6 to the financial statements.