

February 13, 2006

Mr. Richard George
Chair
International Ethics Standards Board
for Accountants
545 Fifth Avenue, 14th Floor
New York 10017
USA

Re. Interpretation of the Code of Ethics' Requirements Relating to Auditor Association with Misleading Information

Dear Mr. George:

We wish to draw the attention of the International Ethics Standards Board for Accountants to serious concerns that we have with respect to Code of Ethics' Requirements Relating to Auditor Association with Misleading Information.

The current IFAC Code of Ethics (hereinafter referred to as "the Code") contains a number of provisions dealing with a professional accountant's association with misleading information (see Appendix 1). We agree that professional accountants should not be associated with misleading information. However, we are concerned about the following issues in relation to these provisions in the Code:

- No further guidance is given as to when information might be misleading in either Part A or B. However, Part C (see Appendix 1) does give further guidance, but this does not apply to Part B. This means that when information might be deemed misleading could be interpreted differently for Part B (professional accountants in public practice, which includes auditors) than for Part C (professional accountants in business, which includes accountant-preparers).
- Based on the treatment of professional accountants' association with misleading information in Part A of the Code, the IAASB applies the term "misleading" in a number of its issued and draft pronouncements (see Appendices 2 and 3), and thereby interprets Part B of the Code for accountants that are in public practice when they audit financial statements. In some of these pronounce-

ments, it is not clear what the relationship between this term and the requirements of the financial reporting framework might be. In others, such as ISA 200, 700 and the proposed ISAs 550 and 701, the IAASB appears to interpret the “misleading test” as going beyond the specific requirements of the applicable financial reporting framework. It is unclear to us whether the International Ethics Standards Board for Accountants actually intended the IAASB to engage in such wide-ranging interpretations of the Code.

As we had pointed out in previous letters (see Appendices 4 and 5) to the IFAC Ethics Committee, these issues have serious legal and ethical consequences in a good number of civil law jurisdictions (but do not appear to affect most common law jurisdictions). Civil law jurisdictions are affected because they often have so-called compliance audits of compliance financial reporting frameworks (see Appendix 6).

The explanation of the issues above is at a rather abstract level. It may be helpful if we attempt to clarify the nature of the issues using an illustrative example from a currently proposed ISA, the current exposure draft of ISA 550 “Related Parties”. In particular paragraph 23 (c) of the current exposure draft of ISA 550 states that the auditor shall evaluate

“(c) **Irrespective of the applicable reporting framework** [bold added for emphasis], whether the effects of the related party relationships and transactions could result in the financial statements being misleading in the circumstances of the engagement.”

This could mean, for example, that in circumstances where

- the financial reporting framework does not require the financial statements to give a true and fair view or be fairly presented, and
- has a very restrictive definition of related party relationships or requires only modest disclosures of these related party relationships,

the auditor would be required to go beyond the requirements of the financial reporting framework to determine whether the financial statement in question are misleading.

We would like to pose the question whether the International Ethics Standards Board for Accountants intended to have the Code’s provision for non-association with misleading information in Part A for all professional accountants interpreted in this way for auditors covered under Part B for professional accountants in public practice, even though paragraph 320.2 in Part C for professional accountants in business does not appear to support such an interpretation. We would like to point out that the current mismatch between the IAASB’s interpretation of paragraphs 110.2 and 110.3 of the Code and the International Ethics Standards Board for Accountants’ interpreta-

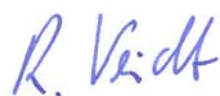
tion thereof in paragraph 320.2 would imply that the responsibilities of professional accountants that audit the financial statements exceed the responsibilities of professional accountants that prepare those financial statements.

From our point of view, this puts auditors in an untenable position.

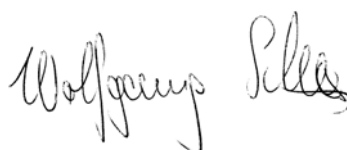
Given the seriousness of these issues, we request that the International Ethics Standards Board for Accountants consider whether the Code may need some minor amendments to clarify these issues. Furthermore, we request that the International Ethics Standards Board for Accountants consider whether it may be desirable to liaise with the IAASB to determine whether IAASB pronouncements are an appropriate vehicle to convey such interpretations of the IFAC Code of Ethics.

Given the importance of this matter to us and other civil law jurisdictions, we would be pleased to be able to be of assistance to you in clarifying the issues in greater depth and would welcome the opportunity to discuss these matters in person.

Yours very truly,



Reiner Veidt



Wolfgang Schaum

494/541/538

Appendices 1-6

cc: John Kellas, Chair IAASB
Jim Sylph, Technical Director IAASB and IESBA
Jan Munro, Technical Manager, IESBA

Appendix 1: IFAC Code of Ethics

Part A of the Code, which applies to both professional accountants in public practice and to those in business, includes the following requirements:

Paragraph 110.2 states

“A professional accountant should not be associated with reports, returns, communications or other information where they believe that the information;

- (a) Contains a materially false or misleading statement;
- (b) Contains statements or information furnished recklessly; or
- (c) Omits or obscures information required to be included where such omission or obscurity would be misleading.”

Paragraph 110.3 goes on to state

“A professional accountant will not be considered to be in breach of paragraph 110.2 if the professional accountant provides a modified report in respect of a matter contained in paragraph 110.2.”

Part B applicable to professional accountants in public practice does not provide any additional guidance on how these requirements apply to professional accountants in public practice, such as auditors.

However, Part C (paragraph 320.2) applicable to professional accountants in business does provide the following requirement:

“A professional accountant in business who has responsibility for the preparation or approval of the general purpose financial statements of an employing organization should ensure that those financial statements are presented in accordance with the applicable financial reporting standards.”

Furthermore, paragraph 320.5 speaks of the “degree to which the information is, or may be, misleading”.

Appendix 2

Flow through from the IFAC Code of Ethics of the term „misleading“ to individual ISA

International Standards on Auditing

The issue of “misleading” information and auditor association therewith is reflected in a number of ISAs, of particular concern are, ISA 200 “Objective and General Principles Governing an Audit of Financial Statements” as amended as a result of ISA 700 (Revised), those ISA dealing with the content of auditor’s reports (ISA 700, 701, 705, 706 and 800) and ISA 550, which deals with related parties.

In addition, in defining adverse opinions, the **IAASB’s Glossary of Terms** states: “An adverse opinion is expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements”.

ISA 200

Paragraph 4 requires the auditor to comply with the IFAC Code of Ethics for Professional Accountants relating to an audit engagement.

Paragraph 47 of ISA 200 provides guidance to the auditor who is performing audit engagements in jurisdictions that do not have an authorized or recognized standard setting organization and states that the auditor may decide to compare the accounting conventions to the requirements of an existing framework considered to be acceptable. It continues to explain that when the auditor makes such a comparison and identifies differences the decision as to whether the accounting conventions adopted by management constitute an acceptable financial reporting framework will include consideration of both the reasons for the differences and of whether application of the accounting conventions could result in financial statements that are misleading.

ISA 210

ISA 210 “Terms of Audit Engagements” has also been amended as a result of ISA 700 (Revised). Paragraph 13, provides guidance to the auditor stating that when law or regulation requires the use of a financial reporting framework for general purpose financial statements and the auditor considers this framework to be unacceptable, the auditor should accept the engagement only if the deficiencies in the framework

can be adequately explained to avoid misleading users. In this way, the auditor is required not to accept the engagement if misleading information will be given to the users, i.e., the auditor should not become associated with misleading information as stated in the Code of Ethics.

According to paragraphs 14 and 15 of ISA 210 where law or regulation prevent the auditor from rejecting the engagement and require management to adopt a financial reporting framework that is not acceptable, the auditor is required to consider the impact on the auditor's report.

ISA 570

The need for the presentation of the financial statements not to be misleading is also referred to in ISA 570 in relation to going concern considerations. According to paragraph 31 of ISA 570: "A material uncertainty exists when the magnitude of its potential impact is such that, in the auditor's judgment, clear disclosure of the nature and implications of the uncertainty is necessary for the presentation of the financial statements not to be misleading." ISA 570 explains further that this material uncertainty, even if adequately disclosed in the financial statements, should be highlighted in the auditors' report by adding an emphasis of matter paragraph once the auditor has evaluated the adequacy of the financial statement disclosure. If, however, adequate disclosure is not made in the financial statements the auditor is required to express a qualified or adverse opinion as appropriate and should in any case include specific reference to the fact that there is a material uncertainty that may cause significant doubt about the entity's ability to continue as a going concern. In this respect ISA 570 expressly requires the auditor is to determine that the financial statements as a whole are not misleading in respect of the going concern assumption.

ISA 700

The version of ISA 700 currently applicable (i.e., not the revised version) in its discussion of an adverse opinion in paragraph 39 states: "An adverse opinion should be expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements."

The revised edition of ISA 700, which will be effective for auditor's reports dated on or after December 31, 2006 deals specifically with extremely rare circumstances when applying the financial reporting framework results in misleading financial statements. In the second sentence of paragraph 15 the standard states: "Application of a financial reporting framework determined to be acceptable for general purpose financial statements will ordinarily result in financial statements that achieve fair presentation. In extremely rare circumstances, however, application of a specific requirement

in a framework that has been determined to be acceptable for general purpose financial statements may result in financial statements that are misleading in the particular circumstances of the entity.” The IAASB further accepts that whether or not the financial reporting framework acknowledges that there may be circumstances where it is necessary for the financial statements to depart from a specific requirement in that framework in order to achieve the objective of fair presentation may differ from financial reporting framework to financial reporting framework. This notwithstanding, paragraph 15 continues: “If the auditor encounters circumstances that lead the auditor to conclude that compliance with this specific requirement results in financial statements that are misleading, the auditor considers the need to modify the auditor’s report.” Such modifications will depend on the circumstances.

The material referred to above (extant ISA 700) in respect of adverse opinion is contained in the current ISA 701 and is effective for auditor’s reports dated on or after December 31, 2006.

ISAs exposed but not yet finalized

ISA 600

The draft of ISA 600 presented to the IAASB in December 2005 no longer refers to misleading. A previous draft, however, did recognize the fact that group management may need to keep certain material sensitive information confidential and recognized that there would be a risk of component management issuing misleading financial statements. Reference to this risk has been dropped as the proposed ISA now requires the auditor to request group management to inform component management in such circumstances, and if group management refuses to do so, to discuss the matters with those charged with governance.

ISA 705

Proposed ISA 705 “Modifications of the Opinion in the Independent Auditors’ Report” which was issued for comment in March 2005 in paragraph 9 (a) and (b) discusses the effects of disagreements with management on the auditors’ report and states: “The auditor expresses an adverse opinion ... when the auditor concludes that the effects of a disagreement with management is material and pervasive to the financial statements such that a qualified opinion is not adequate to disclose a misleading nature of the financial statements.” If, however, the auditor concludes that the effect of any disagreement with management while material is not pervasive and the financial statements prepared in accordance with the applicable financial reporting framework are not misleading the auditor expresses a qualified opinion. Paragraph 9 (c) similarly states that the auditor expresses a qualified opinion when the auditor concludes that the possible effect of an inability to obtain sufficient appropriate audit evidence while

material in the auditors' judgment could not be pervasive. Therefore, the financial statements are not misleading and do not require a disclaimer of opinion.

Paragraph 24 (b) also refers to the misleading nature of the financial statements in discussing how the auditor determines the pervasiveness of the effect of the disagreement with management or the inability to obtain sufficient appropriate audit evidence and in particular considers whether the effect of the disagreement with management on the financial statements can be clearly explained in the auditors' report, so that the modification can address the incomplete or misleading nature of those financial statements.

Paragraph 26 continues in stating: "The auditor ordinarily expresses a qualified opinion when the effect of a disagreement with management or inability to obtain sufficient appropriate audit evidence (a) can be clearly explained in the auditor's report and (b) does not result in financial statements that are misleading as a whole."

When, however, the auditor concludes that the effect of a disagreement with management is material and pervasive to the financial statements and, accordingly, a qualified opinion is not adequate to disclose the misleading or incomplete nature of the financial statements according to paragraph 28 should express an adverse opinion.

Paragraph 30 also deals with expression of an adverse opinion and is concerned with multiple departures from the applicable financial reporting framework which affect multiple financial statement line items. Accumulative effect of the departures may cause the financial statements to be misleading in which case the auditor ordinarily expresses an adverse opinion.

ISA 706

Proposed ISA 706 "Emphasis of Matters Paragraphs and Other Matters Paragraphs in the Independent Auditors' Report", which was also issued for comment in March 2005 deals with other matters paragraphs addressing only matters that are required to be recognized or disclosed in the financial statements by the applicable financial reporting framework. Such matters include, in paragraph 20 (a), "Avoidance of auditor association with misleading information in a document containing audited financial statements". Thus the auditor uses an other matters paragraph to refer directly to the auditor's not being associated with misleading information, as required by section 110 of the Code of Ethics.

Paragraph 21 goes on to refer to ISA 720 which states that the auditor has a responsibility to read the other information in a document containing audited financial statements to identify material inconsistencies or misleading information and provides guidance thereon. Although ISA itself does not include the word "misleading" as it

only refers to material inconsistencies. **Thus the reference to ISA 720 in paragraph 21 of ISA 706 is not correct.** This may also indicate that consideration of misleading information was not foreseen in the original drafting of ISA 720.

ISA 701

Proposed ISA 701 (Revised) the independent auditor's report on other historical financial information was issued for comment in June 2005. Paragraph 24 refers directly to the IFAC Code of Ethics for Professional Accountants quoting paragraph 110.2 thereof, and then going on to explain: "Accordingly, even where the other historical financial information has been prepared in accordance with a framework not designed to achieve fair presentation of the specific information presented, the auditor considers whether the information may be misleading in view of the nature of the entity and its environment, the nature and objective of the financial information, the applicable financial reporting framework and legal or regulatory requirements, the information needs of the intended users and other matters, for example, events, transactions, conditions and practices that may have a significant effect on the engagement."

According to paragraph 25 if, based on the auditor's considerations, the auditor concludes that the other historical financial information is misleading in the circumstances, the auditor discusses the matter with the responsible party and considers the effect on the auditor's report.

ISA 800

The proposed ISA 800 "The Independent Auditors' Report on Summarized Audited Financial Statements", likewise issued for comment in June 2005, quotes paragraph 110.2 from the Code of Ethics in paragraph 25 as rationale for the disassociation required in the preceding paragraph. According to paragraph 24, when, in view of the applied criteria, the summary financial statements do not contain the information necessary so as not to be misleading in the circumstances the auditor requests the responsible party to make appropriate changes to the summary financial statements. Should the responsible party not agree to do so, paragraph 24 then requires the auditor not to express an opinion, unless required by law or regulation to do so, in which case, the auditor should express an adverse opinion.

The necessity that the information presented in summary financial statements be not misleading in the circumstances is considered at various points throughout proposed ISA 800. For instance, paragraph 6 requires the auditor to request the responsible party to acknowledge its responsibility for preparing and presenting an appropriate summary of the financial statements that inter alia, in view of the applied criteria, contains the information necessary so as not to be misleading in the circumstances before accepting an engagement to report on summary financial statements.

In discussing the auditor's considerations in relation to the criteria to be applied in preparing and presenting the summary of the financial statements:

Paragraph 10 provides guidance, noting that because summary financial statements are expected to include only limited disclosure, there is a risk that they may not contain the information necessary so as not to be misleading in the circumstances.

Paragraph 11 provides guidance for the event that established criteria do not exist, repeating the requirement for criteria, which when applied will result in the summary financial statements' containing sufficient information so as not to be misleading in the circumstances.

Paragraph 13 (e) requires the auditor to specifically evaluate, in view of the applied criteria, whether the summary financial statements contain the information necessary so as not to be misleading in the circumstances.

Paragraph 19 (d) requires the auditor's report to identify the responsible party and describe that responsibility for preparing and presenting an appropriate summary of the financial statements that, interalia, in view of the applied criteria, contains the information necessary so as not to be misleading in the circumstances.

ISA 550

ISA 550 "Related Parties" is currently under revision and was issued by the IAASB as an exposure draft for comment in December 2005. Paragraph 23 (c) requires the auditor to evaluate

"(c) Irrespective of the applicable financial reporting framework [bold added for emphasis], whether the effects of the related party relationships and transactions could result in the financial statements being misleading in the circumstances of the engagement."

". The word "misleading" is annotated by footnote referring the requirements of Section 110 of the Code of Ethics and to ISA 700 and [proposed] ISA 701, which provide further guidance on the circumstances when financial information could be considered misleading. Paragraph A29 provides the following application guidance in respect of this issue:

"Evaluating the effects of related party relationships and transactions also enables the auditor to consider whether, irrespective of the applicable financial reporting framework, these effects could result in the financial statements being misleading in view of the nature of the entity and its environment, the nature and objective of the financial statements, the applicable financial reporting framework and legal or regulatory requirements, and other matters (for example, events, transactions, conditions and practices that may have a significant effect on the audit)."

Appendix 3

Other IAASB pronouncements which consider the issue of “misleading”

ISRE 2400

The International Standard on Review Engagements 2400 in discussing the contents of the review report in paragraph 27 (b) (II) should give an adverse statement that the financial statements do not give a true and fair view in accordance with the identified financial reporting framework when the effect of the matter is so material and pervasive to the financial statements that the auditor concludes that the qualification is not adequate to disclose the misleading or incomplete nature of the financial statements.

ISAE 3400

ISAE 3400 “The Examination of Prospective Financial Information” states in paragraph 26: “When assessing the presentation and disclosure of the prospective financial information, in addition to the specific requirements of any relevant statutes, regulations or professional standards, the auditor will need to consider whether; (a) the presentation of prospective financial information is informative and not misleading,” it then lists further items for consideration. Although the word “misleading” does not appear again in this standard paragraph 31 states that “when the auditor believes that the presentation and disclosure of the prospective financial information is not adequate, the auditor should express a qualified or adverse opinion in the report on the prospective financial information, or withdraw from the engagement as appropriate”. Detailed guidance as to when to express a qualified and when to express an adverse opinion are not given in this standard.

ISRS 4410

Finally, the International Standard on Related Services 4410 “Engagements to Compile Financial Statements” likewise, in compliance with paragraph 110 of the Code of Ethics states in paragraph 16 “If the accountant becomes aware of material misstatements, the accountant should try to agree appropriate amendments with the entity. If such amendments are not made and the financial information is considered to be misleading, the accountant should withdraw from the engagement.

IAPS 1006: “Audits of the Financial Statements of Banks”

In IAPS 1006 which deals with audits of the financial statements of banks “misleading” is discussed in connection with window dressing and in particular fraud and fraudulent financial reporting. Firstly, in paragraph 83 which deals with balances with other banks, and in particular, the section thereof on presentation and disclosure

states: “The auditor considers whether the balances with other banks as at the date of the financial statements represent bona fide commercial transaction or whether any significant variation from normal or expected levels reflects transactions entered into primarily to give a misleading impression of the financial position of the bank or to improve liquidity and asset ratios (often known as “window-dressing”).” This goes on to state that the auditor ultimately considers whether to modify the audit report.

IAPS 1014: “Reporting by Auditors on Compliance with International Financial Reporting Standards”

IAPS 1014 refers to paragraph 17 of IAS 1 “Presentation of Financial Statements” which foresees a framework override in extremely rare circumstances in which compliance with a requirement in a standard or an interpretation would be so misleading that it would conflict with the objective of financial statements set out in the framework.

Paragraphs 8 to 11 of IAPS 1014 discuss the need to auditor to consider any disclosure of the extent of compliance with international financial reporting standards in financial statements which have been prepared in accordance with a national financial reporting framework and whether such disclosure may be misleading, together with the impact on the auditor’s report.

Appendix 4

Comment letter sent by the IDW to the Ethics Committee

September 15, 2004

Ms. Marilyn Pendergast
Chair
Ethics Committee
International Federation of
Accountants (IFAC)
545 Fifth Avenue, 14th Floor
New York, NY 10017
USA

Dear Ms. Pendergast:

Re: Proposed Revised Code of Ethics for Professional Accountants and the Implicit Practitioner Override in Part A

We are writing this letter to you to express our concern over content of Section 110.2 in the Proposed Revised Code of Ethics for Professional Accountants. This Section of the latest draft of the Proposed Revised Code (hereinafter referred to as “the Code”) states the following:

“A professional accountant should not, except, for example, when providing a modified report, be associated with reports, returns, communications or other information where they believe that the information:

- (a) Contains a materially false or misleading statement;
- (b) Contains statements or information furnished recklessly; or

- (c) Omits or obscures information required to be included where such omission or obscurity would be misleading.”

We would like to point out that we agree, in principal, with these requirements. However, we are very concerned about how these requirements are being interpreted – and in particular, how they appear to be currently interpreted by the IAASB. On this basis, we believe it to be important that this section contain additional guidance on how it ought to be interpreted. The heart of the problem resides in whether or not Section 110.2 in effect requires a “practitioner override” (also called a “stand back” requirement).

Both the Exposure Draft to revise ISA 700 and related standards, as well as drafts of other standards currently under revision, interpret the requirements in 110.2 to signify that the practitioner has a responsibility to “stand back” from the specific requirements of the applicable financial reporting framework to determine whether the financial statements being audited, as a whole, are presented fairly or give a true and fair view. In other words, a practitioner must apply a “practitioner override” beyond the specific requirements of a financial reporting framework even if that financial reporting framework does not incorporate an override of its specific requirements. An example of a financial reporting framework incorporating such an override is the IFRS, which include such an override in IAS 1.17.

However, we would like to point out that some legally required financial reporting frameworks (such as that required for financial statements of unincorporated commercial businesses by the German Commercial Code, which governs hundreds of thousands of small businesses in Germany) do not incorporate such an override. The applicable legislation thereby denies the auditor any right or responsibility to exercise an override and management any responsibility to exercise an override of the legally defined specific financial reporting requirements. In these circumstances, the auditor does not “stand back” to determine whether the financial statements, as a whole, are fairly presented or give a true and fair view, but merely attests to the compliance of the financial statements with the applicable financial reporting framework as defined by law.

The latest drafts of ISA 700 do not mandate the use of the terms “fairly present” or “true and fair view” where the expression of the audit opinion is at variance with these terms due to legal requirements. Nevertheless, the requirement to “stand back” and apply a practitioner override remains on the basis that this is in line with the requirement of Section 110.2 in the Code for the professional accountant not to be associated with misleading information. In other words, the current drafts of IAASB standards appear to presume that a “pure compliance” audit is considered not acceptable because the preparation of the financial statements in accordance with the applicable financial reporting framework may lead to misleading information.

The question that needs to be clarified in this respect is whether Section 110.2 of the Code actually asks auditors to override legally required financial reporting frameworks if these might be considered inadequate and consequently their application results in misleading information.

We would like to point out that in many civil law countries, including Germany, the law defines the rights and responsibilities of practitioners. Any code of ethics or other professional pronouncements issued by professional organizations or standards setting bodies can only, at most, interpret these legal requirements. Hence, unlike the situation prevalent in most common law jurisdictions, professional organizations or standards setting bodies in many civil law countries such as Germany cannot impose professional requirements on practitioners that go beyond the law. We believe that by asking auditors to “stand back” from the specific requirements of a legally required financial reporting framework regardless of whether or not that framework incorporates an override, the IAASB is interpreting Section 110.2 of the Code to require auditors in Germany to assume responsibilities beyond those that are legally required or possible.

On this basis, we respectfully request the Ethics Committee to consider whether additional clarification of Section 110.2 of the Code may be necessary. We would like to propose adding some wording along the following lines at the end of that section:

“Where information is prepared in accordance with legal requirements and professional accountants do not implicitly or explicitly represent that this information is in compliance with other than these legal requirements, that information and the professional accountant’s representation thereto are presumed not to be misleading.”

If you have any further questions about our views on these matters, we would be pleased to be of further assistance.

Yours truly,

Dr. Wolfgang Schaum
Executive Director

Wolfgang Böhm
Special Advisor to the Executive Board

494/500

cc Mr. Jim Sylph, Technical Director, IAASB and Ethics Committee
John Kellas, Chair, IAASB

Appendix 5

Extract Taken From a Subsequent IDW Comment Letter

IDW Comment letter to IFAC re Code of Ethics dated December 3, 2004

Practitioner override

Section 110 of Part A has been augmented by the addition of the following sentence: "A professional accountant will not be considered to be in breach of paragraph 110.2 if the professional accountant provides a modified report in respect of a matter contained in paragraph 110.2." We believe that this change has not clarified the professional responsibilities of accountants.

We refer to our letter dated September 15, 2004, which details our concerns relating to interpretation of the issue of auditor override together with suggested wording. From your response in your letter dated November 3, 2004, we are under the impression that the Committee may have misinterpreted the nature of our concern. In particular, we believe that the assertion in your letter that this issue is an IAASB matter is misplaced because it also applies to accountants in business that prepare information.

Furthermore, your response stated that a requirement in ISA 700 for an override leading to a modified report would not be regarded as a breach of the ethical requirements in the Code. This was not the issue. The auditor override was incorporated into the current draft of ISA 700 by the ISA 700 Task Force of the IAASB on the basis that the Code requires such an override beyond any requirements in the applicable financial reporting framework. We question whether this is an appropriate interpretation of the Code because this would lead to the rather strange situation that auditors have greater responsibility for the content of the audited financial statements than management does unless management were also professional accountants subject to the Code.

What we are seeking is clarification whether the Code does in fact require professional accountants (including auditors) to override the financial reporting framework if its application leads to misleading financial information. As we pointed out in our letter to you dated September 15, 2004, some legal environments do not allow the auditor to override legal requirements.

However, if the Code were interpreted as including such a requirement, we were seeking some legal protection for professional accountants (including auditors) by allowing them to presume, unless there is evidence to the contrary, that information

prepared in accordance with legal requirements is not misleading and that hence any representations to this effect, if true, also are presumed not to be misleading.

Appendix 6: Compliance Audits

Origins and Nature

Prior to the introduction of the Fourth EU Directive and the internationalization of accounting issues through International Accounting Standards, statutory and voluntary audits of financial statements in most civil law countries represented so-called “compliance audits”. The reason for this is to be found in the difference between civil law and common law environments. While the following description is an oversimplification, it serves to illustrate the reasons for the different development of accounting, and hence auditing, in different jurisdictions.

In general, the primary difference between civil law and common law jurisdictions is that civil law derives its authority almost entirely from statute or the interpretation or analogous application of statutes, whereas in common law jurisdictions judges made law in the absence of applicable statutes. Consequently, civil law systems are highly codified, which generally leaves comparatively (that is, compared to common law environments) little room for judges to “make” law beyond interpreting statutes or applying existing statutes analogously to other situations.

In civil law environments, external accounting requirements for business enterprises are generally codified in commercial or corporate law. While these requirements would be of differing degree of detail in different jurisdictions, external accounting in these environments involve compliance with these requirements and any legal interpretations thereof. Hence, those responsible for preparing the financial statements (management) must comply with the legal accounting requirements, and any significant interpretations of these requirements by court decisions or general legal opinion, applicable to their business enterprise. However, once having complied with these requirements, management is under no legal obligation at all to depart from the specific requirements of the law, or even to provide disclosures beyond those specifically required by the law, to achieve an objective beyond legal compliance (such as a “true and fair view” or “fair presentation”). Hence, in legal proceedings before a court of law, judges in civil law jurisdictions are not in a position to require management to prepare financial statements that depart from the requirements of the law or provide disclosures beyond those specifically required by the law because this would be unconstitutional.

Both legislators and the legal profession in civil law jurisdictions believe that “compliance financial reporting frameworks” are in the public interest because they provide greater legal certainty with respect to management’s reporting obligations for external financial statements and for what the users of these financial statements have a right to expect from these financial statements. In other words, management has greater legal certainty with respect to possible grounds for successful suits against it for improper accounting, and users have greater legal certainty with respect to the possible

suits against management in relation to improper accounting that promise success before the courts. Furthermore, because of the statutory basis for the legal accounting requirements in relation to compliance frameworks, these requirements are deemed to be in the public interest because they have the political legitimacy of having been subject to a full due process for passing legislation through a duly elected legislative assembly.

Compliance audits result from the nature of the compliance financial reporting frameworks in these jurisdictions. Since under a compliance financial reporting framework, management has no obligation to depart from the requirements of the financial reporting framework, nor to provide any disclosures beyond those specifically required by that framework, the auditor is not in a position to qualify the auditor's report if all of the legal accounting requirements have been met. If the auditor chose to qualify despite this, management would be in a position to successfully sue the auditor on the grounds that the auditor had no right to qualify the auditor's opinion when the financial statements meet the applicable legal requirements. On the other hand, the auditor cannot be successfully sued by users for an unqualified auditor's opinion on financial statements prepared in accordance with a compliance framework if the financial statements meet those requirements because there are no legal grounds for the suit.

This is very different from the situation in most common law jurisdictions, where under contract or tort law the courts require information to not contain a "material misrepresentation" beyond mere compliance for matters not directly covered by statute. In other words, both management and the auditor can be sued for the lack of additional disclosure in financial information needed to prevent a material misrepresentation even if the financial reporting framework (which may not be anchored in, or directly sanctioned by, law) were not to specifically require such disclosure.

Use

While most civil law jurisdictions (and all in the EU) have accepted financial reporting frameworks requiring more than just legal compliance for general purpose financial statements for publicly listed or incorporated business enterprises, most special purpose financial reporting frameworks, and some general purpose financial reporting frameworks for smaller, not-for-profit or unincorporated entities, remain compliance – as opposed to "fair presentation" – frameworks. Legislators and the legal profession in many civil law jurisdictions continue to believe that this is in the public interest for the reasons noted above. Consequently, these compliance financial reporting frameworks continue to be very common in civil law jurisdictions.

It should be noted that compliance audits on financial statements prepared in accordance with compliance financial reporting frameworks are consistent with the overall objective of ISA audits of financial statements as described in ISA 200.02, which was

probably originally phrased the way it is specifically to cover compliance audits, as well as audits leading to “fair presentation” opinions.

Auditor’s Opinion for Compliance Audits

Auditors’ reports on financial information prepared in accordance with compliance financial reporting frameworks avoid the use of the terms “true and fair view” or “fair presentation” because the opinion extends only to compliance with the specific requirements of that framework.. Consequently, the opinion is generally expressed along the following lines: “In our opinion, the financial information has been properly prepared in accordance with XY financial reporting framework”, or “In our opinion, the financial information has been prepared in compliance with XY financial reporting framework”. Generally speaking, because compliance frameworks are enshrined in law or regulation, the opinion often makes reference to that law or regulation, e.g. “In our opinion, the financial information has been prepared in compliance with the requirements of XYZ law”.