

## BASIS FOR CONCLUSIONS Section 7060, Auditor Review of Interim Financial Statements

September 2014

This Basis for Conclusions has been prepared by staff of the Auditing and Assurance Standards Board (AASB). It relates to, but does not form part of, Section 7060, AUDITOR REVIEW OF INTERIM FINANCIAL STATEMENTS.

### Purpose of this Basis for Conclusions

This Basis for Conclusions provides a brief summary of the AASB's objectives in developing Section 7060, the public exposure and approval steps for this project and how the AASB dealt with significant matters arising from comments received in response to its Exposure Draft. This information is set out below.

### Background

The development of Section 7060 is part of the AASB's project to revise the "7000 series of standards" that focus primarily on the auditor's role and responsibilities in the capital markets. Section 7060 replaces extant Section 7050 of the same name.

In November 2013, the AASB issued an Exposure Draft of Section 7060 (ED-7060). Four written responses to ED-7060 were received. In addition to the written responses, several consultation sessions with various stakeholders were held to seek input on ED-7060.

The AASB approved Section 7060 at its meeting in June 2014. The Auditing and Assurance Standards Oversight Council confirmed that the AASB followed due process in developing Section 7060 and related consequential amendments prior to their issuance in the CPA Canada Handbook – Assurance.

### AASB's Objective in Developing Section 7060

The AASB's objective in developing Section 7060 is to rewrite the extant standard in the clarity format and make other revisions, as appropriate.

### Significant Matters Arising from Comments in Response to ED-7060

#### *Harmonization with ISRE 2410*

1. One respondent to ED-7060 questioned why the AASB is revising extant Section 7050 in the absence of a clear need to do so. If Section 7050 were to be revised, the respondent suggested that the AASB consider harmonizing the Canadian standard with the International Standard on Review Engagement (ISRE) 2410, *Review of Financial Information Performed by the Independent Auditor of the Entity*.
2. As mentioned above, the key reason for developing Section 7060 is to redraft Section 7050 in the clarity format and to make other appropriate revisions. The redrafting of standards within the Handbook in the clarity format is set out in the AASB's 2013-2016 Strategic Plan. Consultations on the Strategic Plan indicated that stakeholders supported this strategy. The Strategic Plan also sets out the AASB's approach on developing standards other than audits of financial statements. For such standards, the AASB would not automatically adopt the international standards in the same manner in which it adopted the International Standards on Auditing (ISAs). Consultations on the AASB's draft strategic plan indicated that stakeholders supported such an approach. In the case of Section 7060, the reasons for not adopting ISRE 2410 are:
  - (a) ISRE 2410 is not drafted in the clarity format. Adopting ISRE 2410 would be inconsistent with the AASB's goal of redrafting the standards in the clarity format.
  - (b) Section 7060 is developed specifically for the Canadian securities regulatory environment. Representatives of the Canadian Securities Administrators were consulted extensively in the development of Section 7060 to ensure that this Section would be compatible with Canadian securities regulations.

#### *Effectiveness of Interim Reviews*

3. One respondent to ED-7060 provided a summary of an academic study indicating that interim review engagements are not effective, and provided a number of possible reasons as to why interim reviews may not be effective.
4. The AASB appreciates academic research in this area and strongly believes that such research will contribute to improvements in interim reviews. In considering the overall conclusion of the respondent's study indicating that interim reviews are not effective, the AASB noted that there are other studies that indicate that interim reviews are effective. Many participants at consultation sessions, including participants who are members of audit committees, have indicated that the guidance on interim review procedures is particularly useful. Similarly, many practitioners have commented that carrying out interim review procedures has assisted them in identifying financial reporting matters to management and audit committees on a timely basis.

5. The respondent's academic study also alluded to public policy issues such as whether Canadian securities regulations should require publication of the auditor's interim review report or whether interim review engagements should be subjected to inspections by the Canadian Public Accountability Board (CPAB). Changing the existing regime relating to publication of the auditor's interim review report and CPAB inspection mandate would require legal liability reform, amendments to securities legislation and changes to assurance standards. The AASB is monitoring public policy developments in these areas.

*Scope of the Standard*

6. Two respondents to ED-7060 suggested that the scope of Section 7060 be expanded to include reviews of interim financial statements of other entities.
7. Consistent with Section 7050, the scope of Section 7060 is developed specifically for reviews of interim financial statements issued under the provisions of securities legislation. While a practitioner who performs a review of other types of interim financial statements may find Section 7060 useful, the practitioner is responsible for complying with GENERAL REVIEW STANDARDS, Section 8100, and PUBLIC ACCOUNTANT'S REVIEW OF FINANCIAL STATEMENTS, Section 8200, when performing such reviews. The auditor's responsibilities when reviewing interim financial statements outside the scope of Section 7060 are reflected in paragraph A3.

*Materiality*

8. ED-7060 proposed to require the auditor to determine materiality for the interim financial statements as a whole, and to revise materiality in the event that the auditor becomes aware of information that would have caused the auditor to have determined a different materiality initially. Two respondents to ED-7060 disagreed with the proposed requirements. The respondents expressed the view that materiality in an interim review is much more of a qualitative assessment than in an audit and, therefore, it is not necessary for the auditor to establish and document overall and planning materiality in connection with an interim review.
9. The AASB concurred with the respondents' view that it is not necessary to establish and document overall and planning materiality in connection with an interim review engagement. However, the AASB continues to be of the view that the concept of materiality is necessary in an interim review engagement to assist the auditor in determining the nature and extent of the procedures to be performed and evaluating the effect of misstatements. Therefore, Section 7060 requires the auditor to consider materiality with reference to the applicable financial reporting framework as it relates to the interim financial statements to assist the auditor in determining the nature and extent of the procedures to be performed and evaluating the effect of misstatements.

*Risk-Informed Approach*

10. ED-7060 proposed a risk-informed approach to an interim review engagement by requiring the auditor to:
  - (a) obtain an understanding of the entity and its environment to be able to provide a basis to identify risks that are likely to result in material misstatement of the interim financial statements;
  - (b) identify such risks; and
  - (c) consider all material items, and design and perform procedures to focus on addressing those risks.
11. Most respondents to ED-7060 agreed with a risk-informed approach. However, a number of respondents expressed concerns that the proposed requirements go beyond existing practice and appear to require a risk assessment process similar to that in an audit engagement.
12. The AASB noted that there is strong support for a risk-informed approach and is retaining such an approach. The AASB also agreed with the respondents' view that a risk assessment process similar to that in an audit engagement is not necessary for the purposes of an interim review engagement. Section 7060 reflects the AASB's intention by requiring the auditor to:
  - (a) have a sufficient understanding of the entity and its environment to be able to provide a basis to identify the risks; and
  - (b) design and perform procedures to focus on addressing those risks.

*Interim MD&A*

13. Extant Section 7050 required the auditor to respond when the auditor becomes aware of an untrue statement of a material fact when reading the interim Management Discussion and Analysis (MD&A). ED-7060 required the auditor to respond when the auditor becomes aware of a misrepresentation when reading the interim MD&A. Under Canadian securities legislation, the term "misrepresentation" refers to an untrue statement of a material fact or an omission to state a material fact that is required to be stated or that is necessary to make a statement not misleading in the light of the circumstances in which it was made.
14. Many respondents to ED-7060 expressed support for replacing the term "untrue statement of fact" with "misrepresentation", and indicated that using consistent terminology with securities regulations is helpful in assisting audit committee members in fulfilling their role in providing oversight of management. However, a number of respondents to ED-7060 expressed disagreement with replacing the term "untrue statement of fact" with "misrepresentation" for the following reasons:

- (a) The term "misrepresentation" may result in increased likelihood of an auditor being held liable for matters beyond the auditor's knowledge such as matters requiring legal interpretation.
  - (b) Introducing a new term "misrepresentation" instead of using the terminology in Canadian Auditing Standard (CAS) 720, *The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements*, may make it complicated for auditors in considering actions to be taken when the auditor becomes aware of a material misstatement in the interim financial statements or a material misrepresentation in the interim MD&A.
15. With respect to the concern that the use of the term "misrepresentation" would place a higher onus on the auditor relating to the auditor's responsibilities and legal liability exposure vis-à-vis the interim MD&A, it is important to note that the auditor's responsibility to respond to a material misrepresentation only arises if the auditor becomes aware of it. The AASB reaffirmed that this is an appropriate approach and is not overly onerous. Therefore, the term "misrepresentation" is retained. Nonetheless, to address the concern regarding the higher onus, the following guidance is provided in paragraphs A24 and A25:
- The auditor is not required to obtain additional knowledge relating to the information in the interim MD&A beyond what the auditor already possesses as a result of performing the audit of the entity's annual financial statements and the review of the entity's interim financial statements.
  - If the auditor becomes aware of information that indicates that there may be a material misrepresentation in the interim MD&A, and if the auditor's concerns are not dispelled through discussions with management (and, if appropriate, those charged with governance), the auditor may wish to propose to management that it discusses the matter further with the entity's legal counsel. Because legal counsel are experts in legal disclosure requirements, the auditor will normally be able to rely on their opinion regarding how the relevant matters can be resolved appropriately.
16. Regarding the issue of potential confusion as to the auditor's consideration of actions to be taken when the auditor becomes aware of a material misstatement in the interim financial statements or a material misrepresentation in the interim MD&A, the AASB has included references to the specific paragraphs in CAS 720, *The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements*, on actions that could be taken by the auditor.
- Format of the Auditor's Interim Review Report*
17. Consistent with Section 7050, ED-7060 proposed to permit the auditor's interim review report to be delivered to the audit committee either in writing or orally. Many respondents to ED-7060 were of the view that the auditor's interim review report should be required to be in writing. The reasons expressed in support of requiring the report to be in writing include the following:
- (a) A written report helps to avoid misunderstanding.
  - (b) A written report provides tangible evidence that the audit committee has engaged the auditors to perform an interim review and that the interim review has been completed.
18. The AASB debated this issue at length and concluded that the existing approach of permitting the auditor's interim review report to be provided either in writing or orally continues to be appropriate. The AASB's considerations include the following:
- (a) With respect to the reasons provided by respondents in support of requiring the auditor's interim review report to be in writing, the AASB is of the view that it would be highly unlikely that there would be misunderstanding under the securities regulatory framework in which Canadian reporting issuers operate. This is because, in the circumstance when the auditor is engaged to perform an interim review but is unable to complete the engagement, Canadian securities regulations require the entity to disclose the fact that the auditor was unable to complete the interim review, and the reasons as to why the auditor was unable to complete the review. Further, the engagement letter, which is required by Section 7060, and presentations by the auditor to the audit committee, would help prevent misunderstanding.
  - (b) There is precedent in the Handbook that communications intended for the entity that engaged the practitioner can be provided either in writing or orally. This is the case, for example, in Section 7600, REPORTS ON THE APPLICATION OF ACCOUNTING PRINCIPLES, and consent addressed to parties other than Canadian securities regulators in Section 7150, AUDITOR'S CONSENT TO THE USE OF A REPORT OF THE AUDITOR INCLUDED IN AN OFFERING DOCUMENT.
  - (c) The current approach of allowing an auditor to provide an oral report is consistent with practice in the U.S. The AASB did not identify any particular Canadian circumstances that would warrant Canada taking a different approach.
19. In retaining the existing approach of permitting the auditor's interim review report to be provided either in writing or orally, the AASB emphasizes that its intention is to permit flexibility in how the auditor's interim review report is delivered. Consistent with current practice, audit committees that wish to have a written auditor's interim review report can request the auditor to provide the auditor's interim review report in writing.

*Restriction on Use and Disclaimer of Responsibility in the Auditor's Interim Review Report*

20. Paragraph 7050.60(h) required the auditor's interim review report to include a statement restricting the use of the report to the addressee for its assistance in reviewing the interim financial statements ("restriction on use"), and a statement disclaiming responsibility to any third party who may rely on the report ("disclaimer of responsibility"). ED-7060 proposed to retain the restriction on use, but not the disclaimer of responsibility.
21. One respondent to ED-7060 seemed to suggest that the auditor's interim review report should not contain a restriction on use. Another respondent expressed the opposite view, suggesting that the auditor's interim review report should include both the restriction on use and the disclaimer of responsibility.
22. With respect to the restriction on use, the AASB is of the view that this statement is necessary to clarify the purpose of the auditor's interim review report, which is to provide assistance to the audit committee. With respect to inclusion of the disclaimer of responsibility, the AASB is of the view that the disclaimer is unnecessary as the restriction on use alone is adequate in highlighting the purpose of the interim review, and in reducing the likelihood of unwarranted reliance. For these reasons, Section 7060 requires the auditor's interim review report to include a restriction on use, but not a disclaimer of responsibility.

*Prohibition on Issuing a Written Consent*

23. Consistent with Section 7050, Section 7060 prohibits the auditor from issuing a written consent to the inclusion of the auditor's interim review report in a public document unless the written consent is required under securities legislation. One respondent disagreed with this prohibition.
24. Under Canadian securities legislation, if an auditor issues a written consent, directors and officers of the entity may have a "reliance on an expert" defence should there prove to be a misrepresentation in the unaudited interim financial statements. Consequently, directors, officers and others, in the discharge of their statutory responsibilities, may inappropriately rely on the interim review report as the report of an expert and not carry out their own statutory responsibilities. In the AASB's view, such an outcome would not be in the public interest. Accordingly, Section 7060 prohibits the auditor from issuing a written consent. The public interest reasons for the prohibition from issuing a written consent are set out in paragraph A36 of Section 7060.

**List of Respondents to the ED**

Jean Bédard, PhD, FCPA, FCA, and Prof. Lucie Courteau  
 Provincial Auditor of Saskatchewan  
 Grant Thornton LLP and Raymond Chabot Grant Thornton LLP  
 Pricewaterhouse Coopers LLP

**Summary of Participants in Face-to-Face Consultations**

Location	Date	Practitioners	Non-practitioners
Toronto	December 2013	10	
Vancouver	January 2014	17	3
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