

ISA 701 Modifications to the Independent Auditor's Report

Introduction

This paper presents the issues and matters identified by the ISA 701 Task Force to date relating to the revision of ISA 701. The ISA 701 Task Force requests that the IAASB review the issues and address the actions requested in the boxed text.

Issues are discussed in the following areas:

1. Objectives and General Approach
 - a. Retaining the Existing Framework
 - b. Requirements in Other ISAs
2. Scope of ISA 701
 - a. Align Emphasis of Matter with ISA 700
 - b. Relationship to Special Purpose Engagements
3. Emphasis of Matter
 - a. Conceptual Basis
 - b. Going Concern
 - c. Uncertainties
 - d. True and Fair View
 - e. Changes in Accounting Policy
 - f. Additional Regulatory Requirements
 - g. Incorrect Information
4. Qualifications
 - a. Types of Qualifications to be Addressed in ISA 701
 - b. Disagreement With Management
 - i. Align Guidance on Method of Application with Materiality Task Force Proposals
 - ii. Qualification Should Not Be a Substitute for Incomplete Information
 - c. Scope Limitation
 - i. Definition of a Scope Limitation
 - ii. Communicating Scope Limitation
 - iii. Strengthen the Guidance Relating to Acceptance or Withdraw from an Engagements
5. Seriousness of the Qualification to the Auditor's Opinion
 - a. "Except For" Opinion or Adverse Opinion and Disclaimer of Opinion
 - i. The Meaning of "Pervasive"
 - b. Multiple Uncertainties and Disclaimer of Opinion
6. Form and Content
 - a. Use of Subheadings and Specifying Layout of Paragraphs
 - i. Emphasis of Matter
 - b. Content
 - i. Description of Qualification
 - ii. Quantification of Possible Effects

7. Other Issues
 - a. Small Entity Considerations
 - b. Public Sector Perspectives

Objectives and General Approach

RETAINING THE EXISTING FRAMEWORK

The project proposal discussed the possibility of expanding the project scope to consider the efficacy and adequacy of the existing framework for qualifications and emphasis of matter paragraphs but recommended continuing with the existing framework. If the project scope were to be expanded, it will be necessary to extend the project timetable in order for the task force to conduct the necessary research and to allow the IAASB sufficient time to consider and debate alternative concepts / frameworks. The task force is of the view that the issues relating to ISA 701 arose not so much because the existing framework is “flawed” but because the framework may not be applied as intended due to a lack of guidance and clarity of the requirements.

The task force proposes to focus the project on improving ISA 701 with the objectives of:

1. Increasing the consistency in auditor reporting among jurisdictions;
2. Improving the understandability of the auditor’s role and responsibility for qualifications and emphasis of matter; and
3. Enhancing the relevance and usefulness of ISA 701 when qualifications and emphasis of matter are required.

Based on its deliberations to date, the key revisions required to ISA 701 identified by the task force are:

- Clarifying the requirements for matters to be emphasized in the auditor’s report;
- Developing additional guidance about limitations of scope and disagreements with management;
- Developing guidance to assist the auditor in determining whether an except-for opinion, a disclaimer of opinion or an adverse opinion is required; and
- Improving the clarity and understandability by specifying new requirements about the form and content of modified reports.

REQUIREMENTS IN OTHER ISAS

Modifications are covered by the ISAs using a “hybrid” approach – ISA 701 sets out the overall framework with other ISAs containing requirements for other specific circumstances. Generally, the revision of an ISA does not extend to the revision of other ISAs except to the extent conforming changes are necessary. Based on the task force’s review to date, the task force believes only revisions to other ISAs in order to conform to the revision made in ISA 701 will be required. This approach includes making only conforming changes to the following ISAs which contain more extensive requirements for modifications:

- ISA 510 “Initial Engagements—Opening Balances”;
- ISA 570 “Going Concern; and
- ISA 710 “Comparatives”.

However, in the course of revising ISA 701, if the task force determines that a requirement in another ISA is inconsistent with the existing framework or requires revision extending beyond conforming changes, the task force will consider the change required and discuss the matter with the IAASB.

Action Required by IAASB

Does the IAASB agree with the objectives and proposed general approach and project scope for the revision of ISA 701? In particular, does the IAASB agree with focusing the project on strengthening the requirements and improving the guidance based on the existing framework?

Scope of ISA 701

ALIGN EMPHASIS OF MATTER WITH ISA 700

ISA 701 currently deals with both qualifications to the auditor's opinion ("except for" opinion, disclaimer of opinion and adverse opinion) as well as emphasis of matter requirements which do not affect the auditor's opinion.

As noted above, two objectives for the revision of ISA 701 is improving the understandability and enhancing the relevance and usefulness of ISA 701. In considering how to achieve these objectives the task force questioned whether addressing emphasis of matter in the same ISA as qualification is appropriate because emphases of matter do not give rise to qualifications to the auditor's opinion. By placing emphasis of matter requirements in ISA 701, the auditors may confuse or unnecessarily link emphasis of matter requirements with qualifications to the auditor's opinion. Consequently, the task force believes it is more appropriate to place the discussion of emphasis of matter into ISA 700. If the IAASB agrees with this proposal, the task force will continue to revise emphasis of matter requirements with the intention of placing the revised discussion in ISA 700 as part of a conforming change.

The task force also believes ISA 701's use of the word "modify" to mean both qualifications to the auditor's opinion and the inclusion of emphasis of matter paragraphs may also be causing confusion. The term "modify" is difficult to translate in some languages and is not sufficiently distinct from the term "qualify" to allow auditors to clearly distinguish between matters that do and do not affect the auditor's opinion on the financial statements. For these reasons, the task force proposes not to continue using the term modify as a "code" for qualifications and emphasis of matter and will instead refer specifically to qualifications and emphasis of matter in describing these respective matters.

RELATIONSHIP TO SPECIAL PURPOSE ENGAGEMENTS

ISA 701 applies to audits of financial statements and does not specifically address modifications relating to special purpose auditor reports. However, proposed ISA 701 states that the "principles relating to the circumstances when the auditor's report needs to be modified are also applicable to reports on other engagements related to the audit of historical financial information, such as general purpose financial statements for entities of a different nature (for example, a not-for-profit organization) and the special purpose audit engagements described in ISA 800, "The Independent

Auditor’s Report on Special Purpose Audit Engagements” The illustrative reports would be adapted as appropriate in the circumstances.”

The task force agrees with the above proposed guidance and concluded it would be difficult and probably inappropriate to expand ISA 701 to specifically include special purpose auditor’s reports as the ISA 800 Task Force is only beginning its work on revising ISA 800.

Action Required of IAASB

Does the IAASB agree with the task force’s proposal to align emphasis of matter requirements with unqualified opinion by placing the requirements in ISA 700? If so, does the IAASB agree with the task force’s proposal to revise the requirements and make this change as part of a conforming change to ISA 700?

Does the IAASB agree that specific guidance relating to special purpose audit reports should not be included in the scope of ISA 701?

Emphasis of Matter

CONCEPTUAL BASIS

Extant ISA 701 permits the auditor to modify the auditor’s report by including a paragraph to emphasize a matter without affecting the auditor’s opinion. The ISAs contain requirements for specific matters to be reported and ISA 701 also permits (grey letter guidance) an emphasis of matter for other matters including those that do not affect the financial statements.

When developing the project proposal, some IAASB members expressed the view that the purpose and application of emphasis of matter are not sufficiently clear and there is a general lack of guidance in ISA 701 which may be causing inconsistent application of emphasis of matter requirements. Although emphasis of matter is permitted by other national standards, the concept is not permitted in Canada. The reasons expressed in CICA Section 5510 (discussed in the context of contingencies) include:

- It is inappropriate to emphasize a matter that is sufficiently and appropriately accounted for and disclosed;
- The concern that the emphasis may overshadow other items in the financial statements that are equally important; and
- The emphasis may be mistaken for a qualification to the auditor’s opinion.

The task force believes these reasons are valid concerns and given the views expressed by IAASB members, the task force found it necessary to discuss whether the emphasis of matter concept should be retained. Although the national standards reviewed did not have identical requirements, the following circumstances were determined to be significant enough and consistently required to confirm to the task force that an additional emphasis in the auditor’s report is warranted.

1. Circumstances where there are material matters relating to the entity's use of the going concern assumption;
2. Circumstances where there is a risk that the view presented in the financial statements may differ significantly once uncertainties are resolved;
3. Circumstances where the entity departs from generally accepted accounting principles in order to present a true and fair view (as permitted by the applicable financial reporting framework);
4. Circumstances where a change in accounting policy has a significant effect on the comparability of the financial statements; and
5. Circumstances where there is a risk that the auditor is associated with incorrect information. For example:
 - (a) Information that is inconsistent with the audited financial statements;
 - (b) An audit report that is subsequently revised.

Based on its review of the existing requirements in the ISAs and in other national standards, the task force believes the nature of the above circumstances is such that the auditor should be required to include an emphasis of matter in the auditor's report. Including an emphasis will assist the reader in understanding that the matter exists and also reduce the possibility of a mis-communication about the matters. (The above circumstances are further discussed below).

In order to ensure the importance of the auditor's report as the means for communicating audit results is maintained, the inclusion of emphasis of matter paragraphs should be limited to those matters that are significant enough to warrant emphasis. The task force proposes to continue the existing approach in the ISAs of specifying the circumstances / matters where an emphasis of matter is required. However, the approach of restricting emphasis of matter only to those circumstances required by the ISAs was not considered appropriate as this would require the IAASB to identify all possible circumstances, and would seem contradictory to the principles-based / use of judgment approach to developing ISAs. Therefore, the task force proposes that ISA 701 continue to permit the auditor to emphasize other significant matters or unusual circumstance where the auditor determines such an emphasis is necessary. For example, an entity may decide to (or may be required to) prepare its financial statements using a different financial reporting framework (such as when an entity chooses to use IFRS instead of another national framework). The effect of the change to the comparability of the financial statements may cause the auditor to determine that the change warrants further emphasis in the auditor's report.

Action Required by IAASB

Does the IAASB agree with retaining the concept of emphasis of matter? If so:

- a. Does the IAASB agree with the task force's assessment of the circumstances that will require an emphasis of matter?
- b. Does the IAASB agree that ISA 701 should permit other matters to be emphasized?

(It may be helpful for IAASB Members to complete their review of the other issues below relating to the emphasis of matter before responding to these issues)

EMPHASIS OF MATTER AND GOING CONCERN

Although ISA 701.32 requires the auditor to highlight material matters relating to a going concern problem, this requirement is more fully described in ISA 570 “Going Concern”. ISA 570.33 states:

“If adequate disclosure is made in the financial statements, the auditor **should** express an unqualified opinion but modify the auditor’s report by adding an emphasis of matter paragraph that highlights the existence of a **material uncertainty** relating to the event or condition that may cast significant doubt on the entity’s ability to continue as a going concern and draws attention to the note in the financial statements that discloses the matters set out in paragraph 32...”

The task force supports the need for a requirement to emphasize a going concern problem but has not considered the nature and extent of changes that may be required to ISA 701 and ISA 570. In revising ISA 701, the task force intends to consider the following issues:

1. ISA 570.33 refers to material uncertainty but ISA 701’s general requirement relating to uncertainties refers to significant uncertainties. The task force will consider whether emphasis of a going concern matter should relate to material uncertainties and if so, whether this creates an inconsistency with the requirements for other uncertainties in ISA 701;
2. Whether the requirements relating to the emphasis of a going concern matter should continue to be retained in both ISA 701 and ISA 570.

If the revisions considered necessary in ISA 570 extend beyond conforming changes, the task force will discuss the way forward for the revisions with the IAASB.

Action Required by IAASB

Does the IAASB have any views about existing ISA 701 and ISA 570’s requirements to emphasize material matters relating to going concern?

EMPHASIS OF MATTER AND UNCERTAINTIES (OTHER THAN GOING CONCERN)

Significant Uncertainties

In addition to uncertainties arising from specific situation such as a matter affecting the entity’s use of the going concern assumption or a matter giving rise to litigation, ISA 701 contemplates a need to emphasize other significant uncertainties. ISA 701.32 states “The auditor should consider modifying the auditor’s report by adding a paragraph if there is a significant uncertainty (other than a going concern problem), the resolution of which is dependent upon future events and which may affect the financial statements. An uncertainty is a matter whose outcome depends on future actions or events not under the direct control of the entity but that may affect the financial statements”.

Although ISA 701.32 relates to significant uncertainties, ISA 701 does not further provide any description of when an uncertainty becomes a “significant” uncertainty. The term significant suggests that ISA 701 may have intended an uncertainty to be emphasized when a certain threshold level is present (presence of a certain extent of quantitative and qualitative elements). In addition, the

use of significant may create confusion because the term is also used in other ISAs, including ISA 315 for significant risks. The task force will consider the threshold level when an uncertainty should be emphasized as well as whether “significant” is the most appropriate term to be used.

ISA 701 does not distinguish between uncertainties in general and those uncertainties that arise because of the inherent nature of the activities or transactions that the entity undertakes (inherent uncertainties). Most financial statements include estimates that are ordinarily made in the normal course of accounting for balances and transactions or disclosures in the financial statements. For such estimates, the extent of uncertainty may be lower because of the entity’s previous experience with the estimate or the routine nature of the item. Other estimates may have a greater extent of uncertainty because the nature of the item is such that it is inherently more difficult to account for or provide clear disclosure in the financial statements. For example, the nature of certain industries is such that they inherently rely on the use of estimates and assumptions as part of their business processes (e.g. insurance and extractive industries). Consequently, small changes in assumptions may result in significant or pervasive changes to the view presented in the financial statements at the date of the auditor’s report. Certain financial statement items may also be inherently more difficult to estimate because of the nature of the item.

The task force proposes that the guidance in ISA 701 be revised to distinguish inherent uncertainties from uncertainties in general. Given the proposal to limit the use of emphasis of matter, reporting routine uncertainties would not be an appropriate use of emphasis of matter because they may unnecessarily draw attention to the matter and away from other matters. This may also have the effect of diluting the importance of very significant or fundamental uncertainties that are of more relevance to the auditor’s overall reporting objectives. Given the potential impact that a significant inherent uncertainty may have to financial statements, the task force believes the auditor should be required to emphasize significant inherent uncertainties in the auditor’s report.

Action Required by IAASB

Does the IAASB have any views about the definition of “significant uncertainties”?

Does the IAASB agree with the proposals to require significant uncertainties, which include both inherent and situation specific uncertainties, to be emphasized in the auditor’s report?

EMPHASIS OF MATTER AND TRUE AND FAIR VIEW

Some financial reporting frameworks permit management to depart from an accounting standard where this is necessary to ensure that the financial statements give a true and fair view of, or present fairly, the financial position of the entity (true and fair view override). As use of the override is not a common occurrence, the task force believes an emphasis of matter should be required in those rare circumstances when it has been invoked. Requiring emphasis of the override would help to serve two purposes:

- Emphasize to the reader that there has been a departure from expected generally accepted accounting principles in order to present fairly (present a true and fair view) of the financial statements; and

- Confirms that the auditor has considered management’s selection and application of accounting policies in discharging the auditor’s responsibilities (see the second sentence of proposed ISA 700.11 below).

This requirement would only apply to those entities where the applicable financial reporting framework permits the true and fair view override and the guidance from proposed ISA 700.10 and 11 provides the necessary background to explain the override.

Guidance from proposed ISA 700:

10. The auditor makes these judgments by considering the entity’s compliance with specific requirements of the financial reporting framework and the fair presentation of the financial statements as a whole. In some circumstances, failure to disclose relevant information not specifically contemplated by the financial reporting framework, or in extremely rare circumstances, compliance with a specific requirement in the framework itself, may result in financial statements that are so misleading that they fail to give a true and fair view of (or present fairly, in all material respects) for example, in the case of financial statements prepared in accordance with International Financial Reporting Standards (IFRS), the financial position, financial performance or cash flows of the entity. In these circumstances, the auditor discusses with management its responsibilities under the financial reporting framework. Some financial reporting frameworks acknowledge that there may be circumstances when it is necessary for the financial statements to disclose information not specifically contemplated by the financial reporting framework, or extremely rare circumstances when it is necessary for the financial statements to depart from a specific requirement in the framework in order to achieve the objective of fair presentation of the financial statements. Those financial reporting frameworks often provide guidance on the disclosures required in such circumstances. Other financial reporting frameworks, however, may not provide any guidance on these circumstances.
11. The auditor considers the need to modify the auditor’s report, which will depend on how management has addressed the matter in the financial statements and how the financial reporting framework deals with these rare circumstances. Ultimately, the auditor is guided by the ethical responsibility to avoid being associated with information where the auditor believes that the information contains a materially false or misleading statement, or omits or obscures information required to be included where such omission or obscurity would be misleading¹. Accordingly, in making a final judgment on the matter, the auditor needs to be satisfied that the information conveyed to readers in the financial statements together with the auditor’s report is not misleading.

¹ See paragraph 2.2 in Section 2 of the “Proposed Revised Code of Ethics for Professional Accountants” July 2003 Exposure Draft.

Action Required by IAASB

Does the IAASB agree with the proposal to require an emphasis of matter paragraph when the true and fair view override has been invoked?

EMPHASIS OF MATTER AND CHANGES IN ACCOUNTING POLICY

The project proposal queried whether there is a need to include an emphasis of matter for a change in accounting policy or method of application because the change affects the comparability of the financial statements. Changes in accounting policy do arise in practice and relate to changes required by the applicable financial reporting framework or initiated by the entity because of the changing circumstances in the entity's business and operations. Changes are often appropriately accounted for and disclosed because financial reporting standards often contain requirements for changes (for example, IAS 8 "Accounting Policies, Changes in Accounting Estimates and Errors"). However, where there is a significant change, the task force believes the change should be emphasized in the auditor's report. This emphasis assists in drawing attention to the significant effect on the comparability of the current period's financial statements to the previous period, and also to the new policy adopted by the entity.

Action Required by IAASB

Does the IAASB agree that changes in accounting policy(ies) that have a significant effect on the comparability of the financial statements should be emphasized in the auditor's report?

EMPHASIS OF MATTER AND ADDITIONAL REGULATORY REQUIREMENTS

ISA 701.35 permits the use of emphasis of matter for matters other than those required in the ISAs and states "An emphasis of matter paragraph may also be used when there are additional statutory reporting responsibilities".

When the auditor addresses other reporting responsibilities within the auditor's report, proposed ISA 700.43 states "This is ordinarily achieved by addressing the other reporting responsibilities in a separate section of the report that follows the opinion paragraph, and when applicable, any emphasis of matter paragraph on the financial statements." Assuming the final revision to ISA 700 is consistent with the proposed ISA 700, the task force recommends conforming ISA 701 to revised ISA 700.

EMPHASIS OF MATTER AND INCORRECT INFORMATION

Circumstances may exist where there is information that conflicts or is inconsistent with the auditor's report. The ISAs contain the following emphasis of matter requirements with regard to such circumstances:

- **Revised Auditor's Report:**

When after the financial statements have been issued and the auditor becomes aware of a fact that may have caused the auditor to modify the auditor's opinion, and where management revises the financial statements, ISA 560.16 requires the auditor ("**should** statement") to include an emphasis of a matter paragraph referring to a note to the financial statements that more extensively discusses the reason for the revision of the previously issued financial statements and to the earlier report issued by the auditor.

- **Comparatives as “Corresponding Figures”:**
When the auditor’s report on the prior period included a qualification and the matter is resolved, the current report does not ordinarily refer to the previous qualification. However, if the matter is material to the current period, the auditor may include an emphasis of matter paragraph dealing with the situation. (See ISA 710 “Comparatives” paragraph 13).
- **Comparatives as “Comparative Financial Statements”:**
The auditor may become aware of a material misstatement that affects the prior period financial statements on which an unmodified report has been previously issued and the prior period financial statements have not been revised and an auditor’s report has not been reissued, but the corresponding figures have been properly restated, the auditor may include an emphasis of matter paragraph describing the circumstances and referencing to the appropriate disclosures. (See ISA 710 “Comparatives” paragraph 16).
- **Inconsistent Other Information:**
Where other information in documents containing the audited financial statements is materially inconsistent with the audited financial statements and the auditor determines an amendment to the audited financial statements or other information is necessary, and the entity refuses to make the amendment, the auditor should consider including an emphasis of matter paragraph describing the material inconsistency or taking other actions. (See ISA 720 Other Information in Documents Containing Audited Financial Statements paragraph 13).

The task force believes the above circumstances may give rise to a risk of the auditor being associated with incorrect information or information that the auditor is not responsible for. In general, the task force supports retaining the above requirements but as yet has not considered whether any of the above specific requirements need to be strengthened or revised. For example, the guidance in ISA 710 relating to comparatives is not a required procedure but is stated as explanatory guidance.

Action Required by IAASB

Does the IAASB agree with retaining the above requirements?

Qualifications

TYPES OF QUALIFICATIONS TO BE ADDRESSED IN ISA 701

The existing framework covers the following types of qualifications:

Cause of Qualification	Affects the True and Fair View (Fair Presentation) of the Financial Statements	Affects the True and Fair View (Fair Presentation) of the Financial Statements Materially and Pervasively
Disagreement With Management	A "Except for" Opinion	B Adverse opinion
Inability to Obtain Sufficient Appropriate Audit Evidence	C ⁽¹⁾ "Except for" Opinion	D ⁽¹⁾ Disclaimer of opinion

⁽¹⁾ The description of the scope of the audit should be modified as necessary

Proposed ISA 700 refers to additional reporting situations and potential conflicts or matters relating to the financial reporting framework relating to the entity. For example:

Proposed ISA 700.42 states:

"...However, ISA 700 does not provide reporting guidance when the additional requirements are in conflict with the identified financial reporting framework. This could, for example, arise when an entity has a statutory requirement to prepare unconsolidated parent only financial statements in accordance with IFRS. We understand that certain jurisdictions address conflicts between statutory requirements and the identified financial reporting framework by requiring the auditor to provide an unqualified opinion in accordance with the statutory requirements and a qualified opinion in accordance with the identified financial reporting framework."¹

¹ For example, Australian AS 702 states that:

.51 When the application of accounting policies required or allowed by relevant statutory and other requirements has not resulted in a fair presentation in accordance with Accounting Standards and/or UIG Consensus Views:

- (a) an unqualified opinion should be expressed with respect to presentation in accordance with relevant statutory and other requirements; and
- (b) a qualified opinion should be expressed with respect to presentation in accordance with Accounting Standards and UIG Consensus Views as appropriate.

.52 When the accounting policies applied are contrary to those required by relevant statutory and other requirements, the audit opinion should be qualified with respect to presentation in accordance with those requirements, whether or not the auditor's opinion with respect to presentation in accordance with Accounting Standards and UIG Consensus Views is qualified.

Proposed ISA 210.18 states:

“...When the auditor accepts an engagement involving an applicable financial reporting framework that is not established by an authorized international or national standards setting organization, the auditor may encounter deficiencies in that framework that were not anticipated when the engagement was initially accepted and that indicate that the framework is not acceptable for general purpose financial statements. In these circumstances, the auditor discusses the deficiencies with management and the need for management to adopt another financial reporting framework that is suitable. As discussed in paragraph 20, the auditor also refers to the change in the financial reporting framework in a new engagement letter.”

The task force is considering whether it is necessary to expand the existing framework to address these additional reporting situations that arise. If the IAASB agrees to expand the framework, issues that the task force will need to consider include:

1. Whether the above types of situations give rise to a new category of qualification (in addition to disagreements with management and scope limitations) in ISA 701;
2. The types of qualifications that the auditor should be required (bold statement) to issue for certain circumstances; and
3. Additional guidance and / or conforming changes required to ISA 701 and proposed ISA 700 and ISA 200.

Action Required of IAASB...

Does the IAASB believe that the existing framework should be expanded for the additional reporting requirements described above? If so, are there other specific issues in addition to the three issues highlighted above that the task force should consider?

DISAGREEMENT WITH MANAGEMENT

ISA 700.36 currently describes three types of disagreements with management that may give rise to a qualification:

- The acceptability of the accounting policies selected;
- The method of application of the accounting policies; and
- The adequacy of financial statement disclosures.

ISA 700.36 refers to the “acceptability” of accounting policies; however, both ED ISA 700 and ISA 315 “Understanding the Entity and Assessing the Risks of Material Misstatement” use the term “appropriateness” of accounting policies. The task force will conform ISA 701 to the term appropriateness which the task force has defined to mean that the accounting policies are not merely adequate but are suitable for the entity’s circumstance.

The auditor’s evaluation as to whether there is a disagreement with management depends to a large extent on the auditor’s understanding of the entity and its applicable financial framework. ISA 315 (see below) contains guidance that is relevant to the auditor when assessing potential disagreements with management.

ISA 315.28 states:

“The auditor **should** obtain an understanding of the entity’s selection and application of accounting policies and consider whether they are appropriate for its business and consistent with the applicable financial reporting framework and accounting polices used in the relevant industry. The understanding encompasses the methods the entity uses to account for significant and unusual transactions; the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus; and changes in the entity’s accounting policies. The auditor also identifies financial reporting standards and regulations that are new to the entity and considers when and how the entity will adopt such requirements. Where the entity has changed its selection of or method of applying a significant accounting policy, the auditor considers the reasons for the change and whether it is appropriate and consistent with the requirements of the applicable financial reporting framework.”

The task force does not believe it is necessary to repeat this guidance in ISA 701; however, some general guidance to link ISA 701’s definition of disagreements with management to the requirement in ISA 315 will be developed. In addition, given the implicit assumption that changes in accounting principles have been properly determined², the task force proposes including the following guidance to assist the auditor in considering changes in the entity’s accounting policy:

- Whether the new policy is in accordance with the applicable framework
- Whether the method of accounting for the change is in accordance with the applicable framework
- Whether management has provided reasonable justification for the change.

Align Guidance on Method of Application with Materiality Task Force Proposals

Disagreements with management about the method of application of an accounting policy may arise where misstatements have been identified by the auditor. Whether the disagreement requires a qualification to the auditor’s opinion will be affected by factors such as the effect (magnitude) of the misstatement to the financial statements and the nature of the misstatement. The proposed ISA “Materiality in the Identification and Evaluation of Misstatements” (refer to IAASB April 2004 agenda papers) prepared by the Materiality Task Force explains misstatements in the context of the nature and cause of the misstatement. In particular, the proposal classifies misstatements for audit purposes as (a) Known misstatements (b) Likely misstatements, and (c) Misstatements arising from differences in judgment. The proposed ISA also introduces the idea of possible management bias in areas matters involving judgment such as management’s accounting estimates.

The task force believes the auditor’s evaluation of disagreements with management about the method of application should be consistent with the guidance proposed by the Materiality Task Force. Considering the disagreement in the context of Known, Likely and Differences-in-Judgment misstatements arising from differences in judgment and the possibility of management bias will provide a basis for evaluating whether the magnitude and cause of the misstatement requires a

2 Proposed ISA 701.36 (extant ISA 700.27) states “An unqualified opinion also indicates implicitly that any changes in accounting principles or in the method of their application, and the effects thereof, have been properly determined and disclosed in the financial statements”.

qualification to the auditor's opinion and if so, whether the effect is pervasive and material to the financial statements to warrant an adverse opinion.

Action Required by IAASB

Does the IAASB agree that the proposals by the Materiality Task Force are relevant to disagreements about the method of application?

Qualification Should Not be a Substitute for Incomplete Information

In defining the requirement to issue an adverse opinion, ISA 701.39 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".

As currently described, the task force believes auditors may wrongly interpret ISA 701.39 to mean that the qualification may serve as a substitute or compensating disclosure for the misleading or incomplete aspect of the financial statements. As the financial statements are management's responsibility, the auditor's report should not be viewed as a source for information that should be provided in the financial statements. The task force proposes revising the definition of an except for opinion to avoid the possibility of such an interpretation.

Action Required by IAASB

Does the IAASB agree with the need to revise ISA 701 so that a qualification is not interpreted as a suitable substitute for information that is omitted or misleading in the financial statements?

SCOPE LIMITATION

Definition of a Scope Limitation

ISA 701 characterizes a scope limitation as "limitation on the scope of the auditors work" or when the "auditor is unable to carry out an audit procedure believed to be desirable". The task force believes the more important point about a scope limitation is that the auditor has not been able to obtain sufficient appropriate audit evidence and therefore is not able to form an opinion about the matter(s) and intends to revise the guidance accordingly.

Communicating Scope Limitation

Limitation on the scope of the auditor's work may arise because it has been imposed by the entity or it has been imposed by the circumstances of the audit engagement. These two circumstances are discussed in ISA 701. Given an imposition by the entity is a deliberate action by management which prevents the auditor from discharging his responsibilities, the task force believes the wording in the Auditor's Responsibilities section and the Opinion paragraph must be clear that the entity has imposed the limitation.

Strengthen the Guidance Relating to Acceptance or Withdraw From an Engagement

ISA 701.41 states that “when the limitation in the terms of a proposed engagement is such that the auditor believes the need to express a disclaimer of opinion exists; the auditor would ordinarily not accept such a limited engagement as an audit engagement, unless required by statute. Also, a statutory auditor would not accept such an audit engagement when the limitation infringes on the auditor’s statutory duties”. Given the increased emphasis on acceptance and continuance requirements in the Quality Control standards, it may be appropriate to include general guidance or make reference to the Quality Control requirements. With regard to withdraw from the engagement, the task force recognizes that in some jurisdiction it may not be possible for the auditor to withdraw during the course of the audit. The task force will consider including guidance similar to guidance in proposed ISA 240 “Auditor’s Responsibility to Consider Fraud in an Audit of Financial Statements”³.

Action Required by the IAASB

Does the IAASB agree with the proposals to:

- a. Revise the definition of a scope limitation to focus on the sufficiency and appropriateness of the audit evidence obtained?
- b. Requiring the auditor to make clear in the modified report where a scope limitation has been imposed by the entity?
- c. Strengthening the guidance relating to acceptance and withdraw from the audit?

Seriousness of the Qualification to the Auditor’s Opinion**“EXCEPT FOR” OPINION OR ADVERSE OPINION AND DISCLAIMER OF OPINION**

ISA 701 distinguishes the type of opinion to be issued according to whether the effect is material to the financial statements (except for opinion) or whether the effect is so material *and* pervasive to the financial statements (adverse opinion or disclaimer of opinion). ISA 701 is not helpful in assisting the auditor determining which opinion should be issued because specific guidance is largely in the form of example auditor’s reports and there is no additional explanation of “pervasiveness” or materiality in the context of the modification. In addition, the guidance in ISA 320 “Audit Materiality” on the evaluation of misstatements and audit evidence is general in nature and is not specific enough to relate to forming the auditor’s opinion.

³ Guidance from proposed ISA 240 “Auditor’s Responsibility to Consider Fraud in an Audit of Financial Statements”:

33. Because of the variety of the circumstances that may arise, it is not possible to describe definitively when withdrawal from an engagement is appropriate. Factors that affect the auditor’s conclusion include the implications of the involvement of a member of management or of those charged with governance (which may affect the reliability of management representations) and the effects on the auditor of a continuing association with the entity.

34. The auditor has professional and legal responsibilities in such circumstances and these responsibilities may vary by country. In some countries, for example, the auditor may be entitled to, or required to, make a statement or report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities. Given the exceptional nature of the circumstances and the need to consider the legal requirements, the auditor considers seeking legal advice when deciding whether to withdraw from an engagement and in determining an appropriate course of action, including the possibility of reporting to shareholders, regulators or others.

In developing the project proposal, some IAASB members requested the development of practical guidance to assist the auditor in determining which opinion is necessary. The task force believes it will be difficult to develop specific, practical guidance for this area because:

- In practice the matters giving rise to a disagreement with management or scope limitation differs according to the circumstance and requires significant professional judgment.
- There is a risk the guidance may be interpreted as prescriptive guidance or “best practice” when this is not intended.
- The nature of the guidance may be such that it is not appropriate for inclusion in an ISA (but may be more appropriate as a Practice Statement or other guidance).

Alternatively, the task force believes it is possible to provide useful guidance in the form of describing the factors that the auditor should consider when evaluating the effect of scope limitations and disagreements with management. The following factors discussed in CICA Section 5510.13 are appropriate for this purpose and the task force proposes to use this guidance as a basis for revising ISA 701.

Proposed guidance:

In addition to materiality, the auditor would also consider the following factors:

- a. The degree to which the matter impairs the usefulness of the financial statements;
- b. The extent to which the effects of the matter on the financial statements can be determined;
- c. The extent to which the effects on the financial statements can be related to specific items; and
- d. Whether the financial statements are, or may be, misleading.

The Meaning of “Pervasive”

Although the term “pervasive” is not defined in ISA 701, the task force believes the term was intended to convey the thought that the effect (or potential effect) of the scope limitation or disagreement with management is such that it affects the financial statements as a whole. The effect (or potential effect) is ordinarily not limited to an item or number of specific items and therefore the financial statements as a whole is misleading or incomplete.

The task force is of the understanding that in some jurisdictions, the term pervasive is not commonly used or understood and that there may be difficulties in translating or defining in certain languages. Although the task force has not concluded whether to retain the term pervasive, the task force believes its meaning as explained above is essential for the purposes of distinguishing an except for opinion from a disclaimer of opinion and adverse opinion and also for the auditor’s evaluation of the effect (potential effect) of a scope limitation or disagreement with management. The task force therefore proposes to expand the discussion of material and pervasive for the purposes of determining whether a scope limitation or disagreement requires a disclaimer of opinion or adverse opinion.

Action Required by IAASB

Does the IAASB agree with the task force's proposal to develop general guidance to assist the auditor in determining the type of qualification to be issued? In particular, does the IAASB agree:

- a. That the above factors are the key factors to be considered by the auditor?
- b. With the task force's proposed definition of pervasive? Does the IAASB have any views on retaining the term pervasive?

MULTIPLE UNCERTAINTIES AND DISCLAIMER OF OPINION

ISA 700.34 states "The addition of a paragraph emphasizing a going concern problem or significant uncertainty is ordinarily adequate to meet the auditor's reporting responsibilities regarding such matters. However, in extreme cases, such as situations involving multiple uncertainties that are significant to the financial statements, the auditor may consider it appropriate to express a disclaimer of opinion instead of adding an emphasis of matter paragraph" without further explaining how the auditor assesses whether and when it is appropriate to issue a disclaimer of opinion or an unqualified opinion with an emphasis of matter. The task force believes a disclaimer of opinion will be necessary if the potential effect of multiple uncertainties and the complexity of the uncertainties taken together results in the auditor being unable to obtain sufficient appropriate audit evidence about the financial statements as a whole. The task force believes that a disclaimer of opinion may also be appropriate where the outcome of a specific (individual) uncertainty has the potential to affect the view presented in the financial statements as whole. For example, the uncertainty associated with amount and effect of costs required to be provided by new environmental regulation.

Action Required by IAASB

- a. Does the IAASB agree with the task force's proposed requirement to issue a disclaimer of opinion when the nature and potential effect(s) of the uncertainties is so pervasive to the financial statements as a whole that the auditor has not been able to obtain sufficient appropriate audit evidence to form an opinion?
- b. Does the IAASB agree that a single uncertainty may have the potential to affect the financial statements as a whole and require a disclaimer of opinion?
- c. Does the IAASB agree that in such a situation, the auditor should be required (bold statement) to issue a disclaimer of opinion and not just an except for opinion because of the pervasive effect of the single uncertainty?

Form and Content

ISA 700.40 states "Whenever the auditor expresses an opinion that is other than unqualified, a clear description of all the substantive reasons should be included in the report and, unless impracticable, a quantification of the possible effect(s) on the financial statements. Ordinarily, this information would be set out in a separate paragraph preceding the opinion or disclaimer of opinion and may include a reference to a more extensive discussion, if any, in a note to the financial statements." ISA 701 contains very limited guidance on the form and content of modified reports and the guidance available is largely in the form of illustrations. (The task force intends to retain example qualified

auditor's reports. The example reports currently reside in the body of ISA 701 and not in an appendix. As the examples are intended to serve as illustrations only, the task force proposes to move the reports into an appendix and modified as necessary to align the examples for other revisions made to ISA 701.)

USE OF SUBHEADINGS AND SPECIFYING LAYOUT OF PARAGRAPHS

Proposed ISA 700.14 states that "Consistency in the content (*i.e.*, the elements), the layout and the wording of the auditor's report when the audit has been conducted in accordance with the ISAs promotes credibility in the global marketplace by making more readily identifiable those audits that have been conducted in accordance with globally recognized standards. It also helps to promote the reader's understanding and to identify unusual circumstances when they occur. It is important, therefore, that the auditor's report contain all of the elements identified in paragraph 13 and described more fully in the remainder of this ISA".

The task force supports the above guidance and believes an approach of specifying requirements relating to form and content is essential to improving the understandability and relevance of qualified report. Where the auditor issues an opinion other than an unqualified opinion, the reader should be able to clearly understand the reasons for a modified auditor's report and the type of opinion issued by the auditor. Consistency in the content and layout will allow readers to more easily recognize when a qualification has been issued and the effect of the qualification on the auditor's opinion.

To improve the consistency in reporting and understandability of modified reports, the task force proposes to establish requirements (bold letter "should" statements) for the use of subheadings and the placement of the Qualification paragraph and the Opinion paragraph.

The Qualification and Opinion should be separately set out by subheadings that precede the explanatory paragraphs. The Qualification paragraph should describe the reasons for and the possible effects of the qualification. The Opinion paragraph should be set out after the Qualification paragraph and be introduced by a subheading that reflects the type of opinion being issued (for example, Except For Opinion; Disclaimer of Opinion; Adverse Opinion).

Emphasis of Matter

As an emphasis of matter does not affect the auditor's opinion, the task force also proposes that an Emphasis of Matter subheading be used to set out the paragraph. In addition, emphasis of matter paragraphs should follow and not precede the Auditor's Opinion so that the reader clearly understands the opinion formed before being alerted to the matter being emphasized.

CONTENT

ISA 701.40 states: that "Whenever the auditor expresses an opinion that is other than unqualified, a clear description of all the substantive reasons **should** be included in the report and, unless impracticable, a quantification of the possible effect(s) on the financial statements."

Description of Qualification

Although ISA 701.40 refers to “all” the substantive reasons, the task force believes the guidance should be expanded so that ISA 701 clearly indicates that all matters relating to the qualification are described and not just a particularly significant matter. For example, one or two matters may overshadow other problems would also result in a qualification. It is important that the auditor recognize the need to identify and report these other problems as well as the significant matters.

In addition to a description of the reasons for the qualification, the task force believes the qualification paragraph should include a clear statement that the auditor’s opinion has been qualified “except for”, is disclaimed, or is an adverse opinion as a consequence of the reasons described. The task force has not discussed how the sentence is to be constructed but agree it should be in plain English and provide a bridge between the Qualification and the Opinion paragraph.

Quantification of Possible Effects

The task force considered whether impracticality is the appropriate basis for not including a quantification of the possible effects. Other thresholds include where the effect is *incapable* of being quantified or the effect cannot be *reasonably determined*. In principle, the possible effect of a matter is capable of being quantified; however, the amount of effort and additional information necessary to quantify the effect may be greater where information is not readily available to the auditor and may be obtained only by performing more extensive procedures or through the assistance of an expert. The task force does not believe it is reasonable to require this extent of additional effort by the auditor and proposes to retain the existing requirement based on “impracticality” but modified to relate impracticality to what may be reasonably obtainable. For example, the information is reasonably obtainable from management’s accounts and records and that providing the information in the report does not require the auditor to assume the position of a preparer of financial information (consistent with US AU508 footnote 15).

Action Required by IAASB

Does the IAASB agree with the task force’s proposal to strengthen the requirements relating to the form and content by requiring:

- a. The use of subheadings (Qualification, Auditor’s Opinion and Emphasis of Matter); and
- b. The placement of the paragraphs relating to Qualification, Auditor’s Opinion and Emphasis of Matter?

Does the IAASB agree with placing the illustrated auditor’s reports in an appendix instead of the body of ISA 701?

Other Issues

SMALL ENTITY CONSIDERATIONS

Small entity considerations (in IAPS 1005 “The Special Considerations in an Audit of Small Entities”) relating to modifications focuses primarily on illustrations about the (lack) completeness of accounting records. The substance of the guidance in IAPS 1005 is addressed in ISA 701 and the

task force is of the view that the illustration is not sufficiently unique to a small entity to be retained. The task force will liaise with the Small Entity Task Force as part of the normal process of revising ISAs to understand whether there are other matters that should be considered by the task force.

PUBLIC SECTOR PERSPECTIVE

To date, no specific public sector considerations have been identified by the task force.