

**PROPOSED INTERNATIONAL STANDARD ON AUDITING 706  
EMPHASIS OF MATTER PARAGRAPHS AND OTHER MATTERS  
PARAGRAPHS IN THE INDEPENDENT AUDITOR'S REPORT**

(Effective for auditors' reports dated on or after  
[December 31, 2006])

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International Standard on Auditing (ISA) 706, "Emphasis of Matter Paragraphs and Other Matters Paragraphs in the Independent Auditor's Report," should be read in the context of the Preface to the International Standards on Quality Control, Auditing, Assurance and Related Services," which sets out the application and authority of ISAs.

## Introduction

1. This International Standard on Auditing (ISA) establishes standards and provides guidance on:
  - (a) Circumstances when the auditor includes an emphasis of matter paragraph or an other matters paragraph in the auditor's report on the financial statements; and
  - (b) The form and placement of such paragraphs.
2. ISA 700 (Revised), "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements," establishes standards and provides guidance on the auditor's report when the auditor is able to express an unmodified opinion on a complete set of general purpose financial statements prepared in accordance with a financial reporting framework designed to achieve fair presentation.
3. [Proposed] ISA 701, "The Independent Auditor's Report on Other Historical Financial Information," establishes standards and provides guidance on the auditor's report when the auditor is able to express an unmodified opinion on historical financial information other than (a) a complete set of general purpose financial statements prepared in accordance with a financial reporting framework designed to achieve fair presentation, and (b) summary audited financial statements.
4. [Proposed] ISA 705, "Modifications to the Opinion in the Independent Auditor's Report," establishes standards and provides guidance for auditors' reports issued in accordance with ISA 700 (Revised) and [proposed] ISA 701 when the auditor's opinion is modified.
5. The standards and guidance in this ISA are to be applied in circumstances when the auditor includes an emphasis of matter paragraph or an other matters paragraph in an auditor's report issued in accordance with ISA 700 (Revised), [proposed] ISA 701 and [proposed] ISA 705. The Appendix to this ISA provides illustrative reports based on the form and content of the auditor's report as set out in ISA 700 (Revised).

## Emphasis of Matter Paragraph in the Auditor's Report

6. Although the auditor may conclude that sufficient appropriate audit evidence has been obtained on which to base an unmodified opinion on the audited financial statements, the auditor may, in rare circumstances, identify a matter of an unusual nature that has been disclosed in the financial statements as being of such fundamental importance to users' understanding of the financial statements as a whole that it would be appropriate to draw the users' attention to it to highlight its particular significance. For example, it may be appropriate to draw users' attention to an uncertainty that could affect the entity's business as a whole, for example, a going concern uncertainty. An emphasis of matter paragraph in the auditor's report provides the means for the auditor to do so.
7. **The auditor should emphasize in the auditor's report a matter that has been presented and disclosed in the financial statements only when, in the auditor's judgment, the following criteria are met:**

- (a) **The matter is of fundamental importance to the user’s understanding of the financial statements;**
  - (b) **The matter is unusual;**
  - (c) **The auditor has obtained sufficient appropriate audit evidence about the matter; and**
  - (d) **There is no disagreement with management regarding the accounting for, and disclosure of, the matter in the financial statements.**
8. The auditor uses professional judgment in determining when to emphasize a matter in the auditor’s report. Accordingly, even when the above criteria have been met, an emphasis of matter may not be necessary in the particular circumstances of the engagement.
  9. A matter is considered to be fundamental to the user’s understanding of the financial statements if the matter affects, or could affect, the financial statements to such an extent, or is of such importance to the financial statements as a whole, that clear disclosure of the matter is necessary to avoid the financial statements from being misleading<sup>1</sup> to the user.
  10. A matter is considered to be unusual if it occurs infrequently or is out of the ordinary course of business for the entity or its industry.
  11. ISA 570, “Going Concern,” requires the auditor to include an emphasis of matter paragraph in the auditor’s report on financial statements to highlight the existence of a material uncertainty regarding an entity’s ability to continue as a going concern. The auditor draws attention to the disclosure in the financial statements that discusses the going concern uncertainty.
  12. Examples of other circumstances that may meet the criteria set out in paragraph 7 include:
    - An uncertainty related to the future outcome of a major litigation or regulatory action (for example, the pending outcome of a major arbitration case that could affect the entity’s business) (see Example Report 1 in the Appendix);
    - Significant and unusual related party transactions, disclosure of which is fundamental to the user’s understanding of the financial statements (see Example Report 2 in the Appendix);
    - Early application of a new accounting standard (for example, a new International Financial Reporting Standard) that has a material and pervasive effect on the financial statements (i.e., where early application is permitted);

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<sup>1</sup> Section 110 of the IFAC *Code of Ethics for Professional Accountants* (Revised June 2005) requires a professional accountant not to 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, unless the professional accountant provides a modified report in respect of the information.

- A major catastrophe that has had, or continues to have, a significant effect on the entity's business or operations (see Example Report 3 in the Appendix).
13. The inclusion of an emphasis of matter paragraph in the auditor's report does not affect the auditor's opinion. An emphasis of matter is not a substitute for either (a) the auditor's expression of a qualified opinion, an adverse opinion, or a disclaimer of opinion when required by the circumstances of a specific audit engagement (see [proposed] ISA 705), or (b) disclosures in the financial statements that the applicable financial reporting framework requires management to make.
  14. **The auditor should include the emphasis of matter paragraph immediately after the opinion paragraph in the auditor's report and use the heading "Emphasis of Matter." The emphasis of matter paragraph should clearly highlight the matter being emphasized and indicate where relevant disclosures that fully describe the matter can be found in the financial statements.**
  15. The auditor does not make disclosures in the emphasis of matter paragraph beyond those included in the financial statements because doing so may imply that the matter has not been appropriately disclosed or that there is a disagreement with management.

### **Other Matters Paragraph in the Auditor's Report**

16. Considerations regarding the inclusion of an emphasis of matter paragraph in the auditor's report apply only to matters that are presented and disclosed in the financial statements in accordance with the applicable financial reporting framework.
17. The auditor may consider it necessary to use the auditor's report as a means of communicating information relating to matters other than those that are presented and disclosed in the financial statements. Such information is referred to in this ISA as "Other Matters" in order to distinguish it from a matter highlighted in an emphasis of matter paragraph.
18. **The auditor should use a separate paragraph in the auditor's report with the heading "Other Matters" to communicate, where appropriate and not prohibited by law or regulation, matters other than those that are presented and disclosed in the financial statements in accordance with the applicable financial reporting framework.**
19. **The auditor should place the other matters paragraph after the auditor's opinion and any emphasis of matter paragraph.**
20. The content of the other matters paragraph reflects clearly that such other matters are not required to be presented and disclosed in the financial statements.
21. Examples of other matters that are not required to be recognized or disclosed in the financial statements by the applicable financial reporting framework include the following:

- (a) Avoidance of auditor association with misleading information in a document containing audited financial statements (see ISA 720, “Other Information in Documents Containing Audited Financial Statements”).
- (b) Circumstances where the incoming auditor is permitted to refer to the predecessor auditor’s report on the corresponding figures in the incoming auditor’s report for the current period, or where the prior period financial statements were not audited (see ISA 710, “Comparatives”).
- (c) Where standards, laws or generally accepted practice in a jurisdiction require or permit the auditor to provide further explanation of the auditor’s responsibilities in an audit of financial statements or of the auditor’s report thereon (see paragraph 45 of ISA 700 (Revised)).
- (d) In rare circumstances, other matters that the auditor considers relevant to communicate to the user, for example, where the auditor judges it necessary to explain why the auditor is unable to resign from the engagement even though the possible effect of an inability to obtain sufficient appropriate audit evidence due to a scope limitation imposed by management is both material and pervasive.

### **Communication with Those Charged with Governance**

- 22. **Prior to signing the report, the auditor should communicate with those charged with governance regarding emphasis of matter or other matters paragraphs that the auditor will include in the auditor’s report, and the proposed wordings of these paragraphs.**
- 23. Such communication enables those charged with governance to be made aware of the nature of any specific matters that the auditor intends to highlight in the auditor’s report, and provides them with an opportunity to obtain further clarification from the auditor where necessary.

### **Effective Date**

- 24. This ISA is effective for auditors’ reports dated on or after [December 31, 2006].

## Appendix

### Examples of Auditors' Reports that Include Emphasis of Matter Paragraphs or Other Matters Paragraphs

**Example Report 1: Auditor's report with an unmodified opinion; the report contains an emphasis of matter paragraph referring to a significant uncertainty related to pending litigation, and an other matters paragraph referring to a material inconsistency with other information in the annual report containing audited financial statements.**

#### INDEPENDENT AUDITOR'S REPORT

*[Appropriate Addressee]*

#### **Report on the Financial Statements<sup>2</sup>**

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at December 31, 20X1, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

#### *Management's Responsibility for the Financial Statements*

Management is responsible for the preparation and the fair presentation of these financial statements in accordance with International Financial Reporting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

#### *Auditor's Responsibility*

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of

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<sup>2</sup> The subheading "Report on the Financial Statements" is unnecessary in circumstances when the second subheading "Report on Other Legal and Regulatory Requirements" is not applicable.

expressing an opinion on the effectiveness of the entity's internal control.<sup>3</sup> An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence that we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

#### *Opinion*

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

#### *Emphasis of Matter*

We draw attention to Note X to the financial statements, which describes the uncertainty<sup>4</sup> related to the outcome of a lawsuit in which the company is the defendant.

#### *Other Matters*

In the Chairman's Report contained in the Annual Report, it is stated that the company has realized a relative increase in profitability this year over that of the prior year. While this statement is consistent with regard to earnings before interest, taxes, depreciation, and amortization (EBITDA), it is inconsistent with regard to profit for the year determined in accordance with International Financial Reporting Standards, which has decreased from the prior year.

#### **Report on Other Legal and Regulatory Requirements (ISA 700 (Revised), paragraphs 46-49)**

*[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]*

*[Auditor's signature]*

*[Date of the auditor's report]*

*[Auditor's address]*

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<sup>3</sup> In circumstances when the auditor also has a responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, this sentence would be worded as follows: “In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances.”

<sup>4</sup> In highlighting the uncertainty, the auditor uses the same terminology that is used in the note to the financial statements.

**Example Report 2: Auditor’s report with an unmodified opinion; the report contains an emphasis of matter paragraph referring to a significant and unusual related party transaction.**

INDEPENDENT AUDITOR’S REPORT

*[Appropriate Addressee]*

**Report on the Financial Statements<sup>5</sup>**

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at December 31, 20X1, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

*Management’s Responsibility for the Financial Statements*

Management is responsible for the preparation and the fair presentation of these financial statements in accordance with International Financial Reporting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

*Auditor’s Responsibility*

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor’s judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity’s preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity’s internal control.<sup>6</sup> An audit also includes evaluating the appropriateness of accounting policies used and the

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<sup>5</sup> The subheading “Report on the Financial Statements” is unnecessary in circumstances when the second subheading “Report on Other Legal and Regulatory Requirements” is not applicable.

<sup>6</sup> In circumstances when the auditor also has a responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, this sentence would be worded as follows: “In making those risk assessments, the auditor considers internal control relevant to the entity’s preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances.”

reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence that we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

*Opinion*

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

*Emphasis of Matter*

We draw attention to Note X to the financial statements, which discloses the sale and leaseback of the company’s headquarters to the company’s controlling shareholder.

**Report on Other Legal and Regulatory Requirements (ISA 700 (Revised), paragraphs 46-49)**

*[Form and content of this section of the auditor’s report will vary depending on the nature of the auditor’s other reporting responsibilities.]*

*[Auditor’s signature]*

*[Date of the auditor’s report]*

*[Auditor’s address]*

**Example Report 3: Auditor’s report with an unmodified opinion; the report also contains an emphasis of matter paragraph referring to uncertainty regarding the effects of a major catastrophe.**

INDEPENDENT AUDITOR’S REPORT

*[Appropriate Addressee]*

**Report on the Financial Statements<sup>7</sup>**

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at December 31, 20X1, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

*Management’s Responsibility for the Financial Statements*

Management is responsible for the preparation and the fair presentation of these financial statements in accordance with International Financial Reporting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

*Auditor’s Responsibility*

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor’s judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity’s preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity’s internal control.<sup>8</sup> An audit also includes evaluating the appropriateness of accounting policies used and the

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<sup>7</sup> The subheading “Report on the Financial Statements” is unnecessary in circumstances when the second subheading “Report on Other Legal and Regulatory Requirements” is not applicable.

<sup>8</sup> In circumstances when the auditor also has a responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, this sentence would be worded as follows: “In making those risk assessments, the auditor considers internal control relevant to the entity’s preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances.”

reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence that we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

*Opinion*

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

*Emphasis of Matter*

We draw attention to Note X to the financial statements, which describes the uncertainty<sup>9</sup> relating to the continuation of business for the company’s major subsidiary in [Country X] due to the earthquake that occurred during the year.

**Report on Other Legal and Regulatory Requirements (ISA 700 (Revised), paragraphs 46-49)**

*[Form and content of this section of the auditor’s report will vary depending on the nature of the auditor’s other reporting responsibilities.]*

*[Auditor’s signature]*

*[Date of the auditor’s report]*

*[Auditor’s address]*

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<sup>9</sup> In highlighting the uncertainty, the auditor uses the same terminology that is used in the note to the financial statements.

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