

**PROPOSED INTERNATIONAL STANDARD ON AUDITING 705****MODIFICATIONS TO THE OPINION 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) 705, "Modifications to the Opinion 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 that may result in a modification to the auditor’s opinion on the financial statements;
  - (b) The type of opinion appropriate in the circumstances; and
  - (c) The content of the auditor’s report when the auditor’s opinion is modified.
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. The standards and guidance in this ISA are to be applied when the auditor modifies the opinion paragraph in the auditor’s report when engaged to report under ISA 700 (Revised). 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)) where the auditor’s opinion is modified.
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. The standards and guidance in this ISA are to be adapted as necessary in the circumstances of an engagement to report under [Proposed] ISA 701 when the auditor modifies the opinion.
4. This ISA does not apply to engagements covered by [Proposed] ISA 800, “The Independent Auditor’s Report on Summary Audited Financial Statements.” [Proposed] ISA 800 establishes standards and provides guidance when the auditor modifies the opinion paragraph in the auditor’s report issued as a result of an audit of summary audited financial statements.
5. [Proposed] ISA 706, “Emphasis of Matter Paragraphs and Other Matters Paragraphs in the Independent Auditor’s Report,” establishes standards and provides guidance when the auditor’s report is amended to include an emphasis of matter or other matters paragraph, without affecting the auditor’s opinion on the financial statements.
6. **The auditor should modify the opinion in the auditor’s report when:**
  - (a) **The auditor concludes that, based on the audit evidence obtained, the financial statements are not free from material misstatement due to a disagreement with management and, accordingly, are not prepared, in all material respects, in accordance with the applicable financial reporting framework; or**

- (b) **The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements are free from material misstatement.**

**Determining the Type of Modification to the Auditor’s Opinion**

- 7. This ISA establishes three types of modified opinions, namely, a qualified opinion, an adverse opinion, and a disclaimer of opinion, the choice of which will depend upon:
  - (a) Whether there is a disagreement with management or an inability to obtain sufficient appropriate audit evidence; and
  - (b) The auditor’s judgment about the materiality and pervasiveness of the matter giving rise to the modification.
  
- 8. The table below illustrates how the auditor’s judgment about the nature, materiality and pervasiveness of the matter giving rise to the modification affects the type of opinion to be expressed.

Affects or Possibly Affects the Financial Statements		
Nature of Matter Giving Rise to the Modification	Materially but not Pervasively	Materially and Pervasively
Disagreement with management	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

*Materiality*

- 9. [Proposed] ISA 320 (Revised) discusses the factors the auditor considers in determining the materiality of a matter and the importance of considering not only the financial magnitude of the matter but also its qualitative aspects. With respect to a misstatement, circumstances that may affect the auditor’s evaluation of its materiality include, for example, the extent to which the misstatement affects compliance with regulatory requirements and debt covenants, or other contractual requirements.

*Pervasive Effect of a Disagreement with Management or an Inability to Obtain Sufficient Appropriate Audit Evidence*

- 10. The effect of a disagreement with management about one or more matters pertaining to the financial statements is pervasive when the matter or matters affect the financial

statements to such an extent that the financial statements as a whole are misleading.<sup>1</sup> For example, when a disagreement with management relates to multiple departures from the applicable financial reporting framework and those departures affect multiple specific elements, accounts or items in the financial statements, the financial statements as a whole may be misleading because of the cumulative effect of the departures.

11. The possible effect of an inability to obtain sufficient appropriate audit evidence about one or more matters pertaining to the financial statements is pervasive when, in the auditor's judgment, the matter or matters affect, or could affect, the financial statements to such an extent that the auditor is unable to form an opinion on the financial statements as a whole.

## Disagreement with Management

### *Qualified Opinion*

12. **The auditor should express a qualified opinion when the auditor concludes that the effect of a disagreement with management is material, but not pervasive, to the financial statements.**
13. The auditor expresses a qualified opinion when the effect of a disagreement with management, while material but not pervasive:
  - (a) Can be clearly explained in the auditor's report (for example, by quantifying the financial statement effects of an overstatement of cash, revenues, or equity); and
  - (b) Does not result in financial statements that are misleading<sup>2</sup> as a whole.

Example Report 1 in the Appendix illustrates a qualified opinion due to a disagreement with management.

### *Adverse Opinion*

14. **The auditor should express an adverse opinion when the auditor concludes that the effect of a disagreement with management is not only material but also pervasive to the financial statements.**
15. The auditor will ordinarily be able to explain the effect of a disagreement with management in the auditor's report even when the effect of the disagreement is not only material but also pervasive. In some circumstances, however, it may not be possible or practicable for the auditor to determine the extent to which specific elements, accounts or items in the financial statements are, or may be, affected by the disagreement. In these circumstances, it may be impracticable for the auditor to explain in the auditor's report

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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.

the effect of the disagreement. For example, the disagreement may arise in respect of the failure to apply an accounting policy for provision for losses on long-term contracts. In this situation, it may not be practicable for the auditor to determine the extent to which specific elements, accounts or items such as provision for foreseeable losses on contracts, work-in-progress, net income, income tax, equity and any associated disclosures, are, or may be, affected over the relevant reporting periods.

16. Example Report 2 in the Appendix illustrates an adverse opinion due to a disagreement with management.

#### *Nature of a Disagreement with Management*

17. A disagreement with management may arise in relation to:
  - (a) The appropriateness of selected accounting policies;
  - (b) The application of the selected accounting policies; or
  - (c) The appropriateness or adequacy of disclosures in the financial statements.
18. The term “disagreement with management” also encompasses the instance where management acknowledges that the financial statements contain a material departure from the applicable financial reporting framework but management refuses to amend the financial statements for any reason, including cost-benefit considerations.

#### *Appropriateness of Selected Accounting Policies*

19. Disagreements with management about the appropriateness of the accounting policies management has selected may arise when:
  - The selected accounting policies are not consistent with the applicable financial reporting framework.
  - The selected accounting policies are not appropriate in the circumstances and, accordingly, the overall presentation of, and disclosures in, the financial statements are not consistent with the auditor’s understanding of (a) the entity and its environment, and (b) the applicable financial reporting framework.
  - Because of the accounting policies selected by management, the financial statements, including the disclosures, do not faithfully represent the underlying transactions and events in a manner that gives a true and fair view of (or presents fairly, in all material respects) the information in the financial statements.
20. Where the entity has changed its selection of significant accounting policies, the auditor considers the reasons for the change and whether it is appropriate in the circumstances. Financial reporting frameworks often contain requirements for the accounting for, and disclosure of, changes in accounting policies. Where the entity has not complied with these requirements, the auditor considers whether this constitutes a material departure from the requirements of the applicable financial reporting framework, and the effect that such departure may have on the auditor’s opinion.

### Application of the Selected Accounting Policies

21. Disagreements with management about the application of the selected accounting policies may arise when:
- Management has not applied the selected accounting policies consistently with the financial reporting framework, including applying the selected accounting policies consistently between periods or to similar transactions and events (consistency in application); or
  - Based on the audit evidence obtained, the auditor has identified a misstatement of the financial statements due to the method of application of a selected accounting policy (error in application). This may arise when there is a disagreement with management about the underlying facts and circumstances to which the selected accounting policy is applied (for example, a disagreement about estimates for pension liabilities).

### Appropriateness or Adequacy of Disclosures in the Financial Statements

22. Disagreements with management about the appropriateness or adequacy of disclosures in the financial statements may arise when:
- (a) The disclosures present information that is not relevant, reliable, comparable or understandable; or
  - (b) The financial statements do not include all of the disclosures required by the applicable financial reporting framework.

### Inability to Obtain Sufficient Appropriate Audit Evidence

#### *Qualified Opinion*

23. **When the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the possible effect on the financial statements of that inability is material but not pervasive, the auditor should express a qualified opinion.**
24. The auditor expresses a qualified opinion when:
- (a) It is possible to determine and clearly describe in the auditor's report which specific elements, accounts or items in the financial statements are, or may be, affected by the inability to obtain sufficient appropriate audit evidence; and
  - (b) Such inability does not impair the auditor's ability to form an opinion on the financial statements as a whole.
25. Example Report 3 in the Appendix illustrates a qualified opinion due to an inability to obtain sufficient appropriate audit evidence.

#### *Disclaimer of Opinion*

26. **When the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the possible effect on the financial statements of**

**that inability is not only material but also pervasive, the auditor should disclaim an opinion on the financial statements.**

27. Ordinarily, when the possible effect of an inability to obtain sufficient appropriate audit evidence is not only material but also pervasive, it will not be possible for the auditor to determine which specific elements, accounts or items in the financial statements are, or may be, affected. Accordingly, it may be impossible for the auditor to clearly describe in the auditor's report the effect of the inability on the financial statements.
28. In some circumstances, however, the auditor may be able to describe the possible effect of an inability to obtain sufficient appropriate audit evidence that is not only material but also pervasive when that possible effect is clearly confined to a limited number of specific elements, accounts or items in the financial statements.
29. Example Report 4 in the Appendix illustrates a disclaimer of opinion due to an inability to obtain sufficient appropriate audit evidence.

*Possible Consequences of Multiple Uncertainties*

30. The existence of one or more material uncertainties ordinarily does not, in itself, result in an inability for the auditor to form an opinion. If the auditor concludes that sufficient appropriate audit evidence has been obtained to support management's assertions about each of the uncertainties and their presentation and disclosure in the financial statements, an unmodified opinion is appropriate, regardless of the cumulative effect of the uncertainties. The auditor may highlight these uncertainties through an emphasis of matter paragraph in the auditor's report (see [proposed] ISA 706).
31. In extreme cases involving multiple uncertainties that have, or could have, a material and pervasive effect on the financial statements, however, the auditor may be unable to obtain sufficient appropriate audit evidence regarding management's assertions about these uncertainties or their presentation and disclosure in the financial statements. In such cases, the auditor disclaims an opinion.

*Nature of an Inability to Obtain Sufficient Appropriate Audit Evidence*

32. The auditor's inability to obtain sufficient appropriate audit evidence (also referred to as a limitation on the scope of the audit) may arise from:
  - (a) Circumstances beyond the control of the entity;
  - (b) Circumstances relating to the nature or timing of the auditor's work; or
  - (c) Limitations imposed by management.
33. The auditor may consider that an inability to perform a specific procedure does not constitute a scope limitation if the auditor is able to obtain sufficient appropriate audit evidence by performing alternative procedures. If performing alternative procedures is not possible, the auditor will not be able to obtain sufficient appropriate audit evidence and, accordingly, qualifies the opinion or disclaims an opinion. Limitations imposed by

management may have other implications for the audit, for example, the auditor's assessment of fraud risks and consideration of engagement continuance.

34. Examples of circumstances beyond the control of the entity include:
- When the entity's accounting records have been destroyed due to a fire.
  - When the entity's financial information has been irretrievably lost due to hardware failure of the entity's computerized information system.
35. Examples of circumstances relating to the nature or timing of the auditor's work include:
- When the auditor determines that performing substantive procedures alone are not sufficient, but the entity's controls are not effective.
  - When the entity is required to use the equity method of accounting for an associated entity, and the auditor is unable to obtain sufficient appropriate audit evidence about the latter's financial information to examine the application of the equity method.
  - When the timing of the auditor's appointment is such that the auditor is unable to observe the counting of the physical inventories.
36. Examples of an inability to obtain sufficient appropriate audit evidence arising from a scope limitation imposed by management include:
- When management precludes the auditor from observing the counting of the physical inventory.
  - When management prevents the auditor from requesting external confirmation of specific account balances.

*Consequence of an Inability to Obtain Sufficient Appropriate Audit Evidence due to a Management-imposed Limitation After the Auditor has Accepted the Engagement*

37. **If, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit which the auditor considers likely to result in the need to express a qualified opinion or to disclaim an opinion on the financial statements, the auditor should request the removal of that limitation. If management refuses, the auditor should consider the implications for the audit and whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence on which to base an unmodified opinion. If performing alternative procedures is not possible, the auditor should qualify the opinion or disclaim an opinion.**
38. **If, after the auditor has accepted the engagement, management imposes a scope limitation that the auditor is unable to overcome through the performance of alternative procedures, and the scope limitation relates to matters that are, or could be, not only material but also pervasive to the financial statements, the auditor should consider resigning from the audit where permitted by law or regulation.**

39. In certain circumstances, resignation from the audit may not be possible if the auditor is required to continue the audit engagement by law or regulation. This may be particularly the case for national audit agencies that are appointed to audit the financial statements of public sector entities. In such cases, the appropriate response for the auditor to a scope limitation imposed by management, the effect of which is not only material but also pervasive to the financial statements, is to disclaim an opinion on the financial statements.

### **Prohibition on Issuing a Piecemeal Opinion**

40. For the purpose of this ISA, a piecemeal opinion arises when the auditor has expressed an adverse opinion or disclaimed an opinion on the financial statements as a whole and, in the same report, expresses an unmodified opinion on one or more specific elements, accounts or items in the financial statements with respect to the same financial reporting framework.
41. **If the auditor has expressed an adverse opinion or disclaimed an opinion on the financial statements as a whole, the auditor should not express an unmodified opinion on one or more specific elements, accounts or items in the financial statements in the same report and with respect to the same financial reporting framework.**
42. Specific elements, accounts or items in the financial statements may include, for example, the revenue item in the income statement, or specific disclosures in the financial statements. Such a combination of an unmodified opinion on one or more of these specific elements, accounts or items, and an adverse or disclaimed opinion on the financial statements as a whole, in the same report and with respect to the same financial reporting framework, tends to be contradictory. It is accordingly not permitted.

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

43. **Prior to signing the report, the auditor should communicate with those charged with governance the circumstances that lead to expected modifications to the opinion in the auditor's report, and the proposed wording of the modification.**
44. Such communication enables:
- (a) Those charged with governance to be made aware of the expected modification(s) and the reasons (or circumstances) for the modification(s);
  - (b) The auditor to agree the facts in respect of the matter(s) giving rise to the expected modification(s), or to confirm matters of disagreement with management as such; and
  - (c) Those charged with governance to have an opportunity, where appropriate, to provide the auditor with further information and explanations in respect of the matter(s) giving rise to the expected modification(s).

## **Form and Content of the Auditor's Report when the Opinion is Modified**

### **Basis for Modification Paragraph**

45. Consistency in the auditor's report helps to promote the users' understanding and to identify unusual circumstances when they occur. Accordingly, although uniformity in the wording of a modified opinion and in the description of the basis for the modification may not be possible, consistency in both the form and content of the auditor's report is desirable.
46. **When the auditor modifies the opinion on the financial statements, the auditor should, in addition to the specific elements required by ISA 700 (Revised) and [proposed] ISA 701, include a paragraph in the auditor's report that provides:**
- (a) **A description of the matter giving rise to the modification; and**
  - (b) **A description of the substantive reasons for the modification.**

**The auditor should place this paragraph immediately before the opinion paragraph in the auditor's report and use the heading "Basis for Qualified Opinion," Basis for Adverse Opinion," or "Basis for Disclaimed Opinion," as appropriate.**

47. If the modification results from a disagreement with management about a specific element, account or item in the financial statements, the auditor's description of the substantive reasons for the modification encompasses:
- (a) Where the disagreement relates to part or all of a financial statement (for example, a cash flow statement) that has been omitted, or not provided to the required level of detail, a description of the nature of the omitted information; or
  - (b) Where the disagreement otherwise relates to:
    - (i) Specific amounts included, or not accounted for, in the financial statements, a description of the financial effects of the disagreement, unless impracticable (for example, the effects on income tax, net income and equity if inventory is overstated); or
    - (ii) Incorrect or misleading qualitative disclosures, an explanation of why the disclosures are incorrect or misleading.
48. If the modification results from an inability to obtain sufficient appropriate audit evidence, the auditor's description of the substantive reasons for the modification encompasses the reasons for the inability to obtain such audit evidence.
49. An adverse or disclaimed opinion does not justify the omission of a description of other identified matters that would require a modification, for example disagreements with management about the recognition, measurement, or disclosure of certain assets and liabilities (for example, the existence of inventory). Accordingly, the auditor describes in the basis for modification paragraph the reasons for all matters that would require a modification to the opinion, and the effects thereof.

**Modified Opinion Paragraph**

50. **When the auditor modifies the audit opinion, the auditor should use the heading “Qualified Opinion,” “Adverse Opinion,” or “Disclaimed Opinion,” as appropriate, for the modified opinion paragraph.**
51. Inclusion of this paragraph heading makes it clear to the user that the auditor’s opinion is modified and indicates the type of modification.
52. **When the auditor expresses a qualified opinion, the auditor should state in the modified opinion paragraph that, in the auditor’s opinion, except for the effects of the matter(s) described in the Basis for Qualified Opinion paragraph, the financial statements give a true and fair view (or “present fairly, in all material respects”) in accordance with the applicable financial reporting framework. When the modification arises from an inability to obtain sufficient appropriate audit evidence, the auditor should use the corresponding phrase “except for the possible effects of the matter(s) ...” for the modified opinion.**
53. Other phrases such as “with the foregoing explanation” or “subject to” are not sufficiently clear or forceful and are not used.
54. **When the auditor expresses an adverse opinion, the auditor should state in the modified opinion paragraph that, in the auditor’s opinion, because of the significance of the matter(s) described in the Basis for Adverse Opinion paragraph, the financial statements do not give a true and fair view (or “do not present fairly”) in accordance with the applicable financial reporting framework.**
55. **When the auditor disclaims an opinion, the auditor should state in the modified opinion paragraph that, because of the significance of the matter(s) described in the Basis for Disclaimed Opinion paragraph, the auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion and, accordingly, the auditor does not express an opinion on the financial statements.**

**Description of Auditor’s Responsibility when the Auditor Disclaims an Opinion**

56. **When the auditor disclaims an opinion, the auditor should amend the introductory paragraph of the auditor’s report to state that the auditor was engaged to audit the financial statements. The auditor should also amend the description of the auditor’s responsibility and the description of the scope of the audit to state only that “the auditor’s responsibility is to express an opinion on the financial statements based on the audit. Because of the matter(s) described in the Basis for Disclaimed Opinion paragraph, however, the auditor was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.”**

**Effective Date**

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

## Appendix

### Examples of Auditors' Reports with Modifications to the Opinion

**Example Report 1: Auditor's report with a qualified opinion due to a disagreement with management – overstatement of inventories. The effect of this disagreement with management is deemed to be material but not pervasive to the 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 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>3</sup> An audit

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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.

<sup>3</sup> In circumstances when the auditor also has 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

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 we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

*Basis for Qualified Opinion*

The company's inventories are recognized in the balance sheet at xx million. We do not agree with management regarding the amounts at which the inventories are stated. With effect from this reporting period, management has ceased to measure them at the lower of cost and net realizable value, which constitutes a departure from International Financial Reporting Standards. Had management measured the inventories at the lower of cost and net realizable value, an amount of xx million would have been required to write them down to their net realizable value. Cost of sales would have been increased by xx million, and income tax, net income and shareholders' equity would have been reduced by xx million, xx million and xx million, respectively.

*Qualified Opinion*

In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion paragraph, 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.

**Report on Other Legal and Regulatory Requirements**

*[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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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."

**Example Report 2: Auditor’s report with an adverse opinion due to a disagreement with management relating to the non-consolidation of a subsidiary. The effect of this disagreement with management is deemed to be not only material but also pervasive to the financial statements.**

## INDEPENDENT AUDITOR’S REPORT

*[Appropriate Addressee]*

### **Report on the Financial Statements<sup>4</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 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>5</sup> An audit

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<sup>4</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>5</sup> In circumstances when the auditor also has 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.”

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 we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

*Basis for Adverse Opinion*

As explained in Note X, with effect from this reporting period, the company ceased to consolidate the financial statements of its subsidiary. This investment is now accounted for on a cost basis. Under International Financial Reporting Standards, the subsidiary should have been consolidated because it is controlled by the company. Had consolidated financial statements been prepared, the effect on the accompanying financial statements would have been material and pervasive. The audited financial statements of the subsidiary show that, while the company's proportionate share in the underlying book values is greater than the cost of investment, substantial losses have been incurred during the reporting period, of which the company's share on consolidation would amount to approximately xx million.

*Adverse Opinion*

In our opinion, because of the significance of the matter discussed in the Basis for Adverse Opinion paragraph, the financial statements do not give a true and fair view of (or "do not present fairly") 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.

**Report on Other Legal and Regulatory Requirements**

*[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 a qualified opinion due to the auditor’s inability to obtain sufficient appropriate audit evidence regarding an investment in a foreign affiliate. The possible effect of the inability to obtain sufficient appropriate audit evidence can be clearly described in the auditor’s report and, while material, is not deemed to be pervasive to the financial statements.**

## INDEPENDENT AUDITOR’S REPORT

*[Appropriate Addressee]*

### **Report on the Financial Statements<sup>6</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 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>7</sup> An audit

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<sup>6</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>7</sup> In circumstances when the auditor also has 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

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 we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

*Basis for Qualified Opinion*

ABC Company's investment in XYZ Company, a foreign associate accounted for by the equity method, is recognized at xx million on the balance sheet as at December 31, 20X1, and ABC's share of XYZ's net income is recognized at xx million in ABC's income statement for the year then ended. We were unable to obtain sufficient appropriate audit evidence about the carrying value of ABC's investment in XYZ as at December 31, 20X1 and ABC's share of XYZ's net income for the year because we were not given access to the accounting records, management, or the auditors of XYZ. We were not able to determine whether any adjustments might have been necessary to these amounts had we been able to obtain such access.

*Qualified Opinion*

In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion paragraph, 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.

**Report on Other Legal and Regulatory Requirements**

*[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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fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances."

**Example Report 4: Auditor’s report with a disclaimed opinion due to the auditor’s inability to obtain sufficient appropriate audit evidence. Completeness of accounting records cannot be substantiated due to lack of control over sales. The possible effect of this inability to obtain sufficient appropriate audit evidence is deemed to be not only material but also pervasive to the financial statements.**

## INDEPENDENT AUDITOR’S REPORT

*[Appropriate Addressee]*

### **Report on the Financial Statements<sup>8</sup>**

We were engaged to audit 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 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 the audit. Because of the matter described in the Basis for Disclaimed Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

#### *Basis for Disclaimed Opinion*

The Company’s sales are made entirely on a cash basis. The Company’s accounting records for cash sales were inadequate for the purposes of our audit and there were no satisfactory audit procedures that we could have performed to obtain reasonable assurance that all cash sales were properly recorded. As a result, we were unable to determine whether any adjustments would be required in respect of recorded or unrecorded sales, recorded or unrecorded cash receipts, and the elements making up the statements of income, changes in equity and cash flows.

#### *Disclaimed Opinion*

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<sup>8</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.

Because of the significance of the matter described in the Basis for Disclaimed Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on the financial statements.

**Report on Other Legal and Regulatory Requirements**

*[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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